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THE SOCIAL SECURITY TRUST FUND SURPLUS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

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THE SOCIAL SECURITY TRUST FUND SURPLUS

THURSDAY, JUNE 15, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:34 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Upton; and Senator Bryan.

Also present: Joseph J. Minarik, executive director; and David Podoff and Joe Cobb, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

This morning we examine the implications of the buildup of the Social Security trust fund surplus. Under current law the cash benefit programs of Social Security are scheduled to accumulate reserves of about $12 trillion by the year 2030. The buildup of the trust fund presents a unique opportunity for the Federal Government directly to increase saving in a period in which it is generally agreed that our national saving rate is too low.

Among the questions raised by the buildup of the trust fund are the following:

Should the Government attempt to increase directly the rate of national saving and, if so, by how much?

Is the Social Security trust fund buildup an appropriate vehicle for increasing national saving?

What are the implications of the trust fund buildup for budget policy, for the financial soundness of the Social Security program, and for economic growth?

The committee is pleased to have three experts on the Social Security program—Robert M. Ball, former Commissioner, Social Security Administration; Isabel V. Sawhill, senior fellow, the Urban Institute; and John H. Makin, director, Fiscal Policy Studies, American Enterprise Institute.

Your prepared statements, of course, will be entered into the record. We ask that you keep your oral testimony relatively brief so that we will have some opportunity for questions.

We will begin with you, Mr. Ball, as the first witness and just move across the table.

STATEMENT OF ROBERT M. BALL, FORMER COMMISSIONER, SOCIAL SECURITY ADMINISTRATION

Mr. BALL. Mr. Chairman, the first part of my prepared statement is entirely factual, and I will just skip that part on the theory that the committee has available to it a description of the present situation and a discussion of why we are in the fortunate position we are as compared with 1981 and 1982, when the papers were full of talk of bankruptcy of Social Security.

So I will proceed immediately to the policy questions involved and, insofar as the committee wants to, we can go into the factual situation in the question period.

Mr. Chairman, there are differences of opinion among experts as to whether Social Security ought to accumulate large reserves, but as far as I know, there is no difference of opinion about the fact that if we do accumulate reserves that they ought not to be used solely as a substitute for general taxes and used for the payment of current operating expenses. So although we can leave aside for the moment the issue of whether to accumulate the surpluses or not, there is wide agreement that the present practice should be changed.

The desired result—in fact, the only excuse for having large Social Security reserves—is to increase the size of the pool of goods and services later on. Such an increase makes it easier to support the retirees of the future. This result can be accomplished by bringing the non-Social Security budget down to approximate balance so that the Social Security annual surpluses then buy up existing Government debt and release private funds for investment in private industry.

But there is another possibility. Not all Federal expenditures are for current consumption. Some are important investments in the future—health care for children and pregnant women, roads, bridges, education, job training, and so on.

If we could carefully define what Federal investments are and use Social Security reserves to increase what is going into those investments, a higher volume of goods and services in the future would result as surely as freeing up funds for private investment.

At present Social Security has been taken out of the unified budget by basic law, but the Gramm-Rudman-Hollings amendment put the annual surpluses back in for the purpose of deficit reduction targets. I believe it would be easier to prevent using Social Security annual surpluses for current operating expenses if we were to stop counting the surpluses for deficit reduction purposes. Making this change would focus attention on reducing the non-Social Security deficit.

Now, although I believe it is highly desirable to completely remove Social Security from the deficit targets, I would not recommend doing so immediately or all at once. It is going to be difficult enough to bring the unified budget, including Social Security, down to the deficit targets. To remove Social Security annual surpluses from the targets now would result in great pressure to cut programs which should not be cut and would make it even more difficult to spend additional money where it should be spent.

I would propose, rather, that we run out the Gramm-Rudman-Hollings targets with the present accounting methods and then gradually reduce the non-Social Security deficit after that.

The final goal I would favor would be either to reduce the non-Social Security deficit to appoximately zero so that the Social Security surpluses represented the surplus in the unified budget, which would result in increased private saving, or alternatively, the deficit for non-Social Security operating expenses could be eliminated but government investment could be allowed to grow. The growth in Social Security reserves could be the source of these additional government investments.

The difficulty with this latter course is in knowing where to draw the line. Some government investments are clear cut, but other expenditures have some of the characteristics of both current consumption and investment. I think it is a good policy, but difficult to carry out.

I believe overall that the policies I have described would be best for the country's future, but I also believe that they would be best from the narrower perspective of Social Security. I believe that the stability of the Social Security benefit structure will be enhanced by a policy that uses Social Security reserves to increase the total volume of goods and services in the future.

The support of the retirees of the baby-boom generation will be easier if the total volume of production is greater than it would otherwise be, and the payment of promised benefits will be more certain the easier it is to make those payments.

Moreover, it seems to me that to the extent it can be shown that the current generation is paying for its own consumption and, in addition, is saving for its future retirement, the more certain it is that the Social Security promises made to that generation will be honored.

I believe that one change should be made in the present design of Social Security financing. The present plan of a big buildup in reserves and then a dissipation of the reserves might make sense if the retirement cost of the baby-boom generation was a one-time cost followed by a lower continuing cost—a sort of rabbit through the Python phenomenon—but such is not the situation.

Instead, the baby-boom retirees establish a new plateau of costs which stay more or less level on into the future. This is because fertility rates are expected to remain low, holding down the size of the work force, and mortality rates are expected to continue to improve so that retirees will live longer.

If we are going to build this reserve, as called for by the present law, I believe we ought to maintain it. One way to do this is to schedule a tax rate increase around, say, 2030, which is the time when the trust funds reach their maximum point under the II-B estimate of the board of trustees. A tax increase of about 1 percentage point for employees and the same for employers would maintain the trust fund beyond the 75 years for which the estimates are made. As a matter of fact, in nominal terms it would continue to grow, but would drop in relation to the next year's outgo, so that by the end of the 75 years it would become a reasonable contingency reserve. A safe contingency reserve is usually taken to be 100 to 150 percent of the next year's outgo. What would happen under such a plan, increasing the rates 1 percentage point each on employers and employees about 2030, is that at the end of the 75-year period, instead of a zero fund as is predicted under the present plan, you would have an adequate contingency reserve of about 100 to 150 percent of the next year's outgo. You would have gained in addition, two generations of substantial savings, which would do all the things that I have previously mentioned.

The trust fund bonds, instead of being cashed in, would be a permanent income producing source for Social Security. It would not be necessary to raise taxes to redeem the bonds, though of course it would be necessary to use general revenue to pay interest on the bonds.

Mr. Chairman, I want to be very clear that although I see advantages for Social Security in these large trust fund accumulations and even more advantages for the future of the economy, I certainly do not consider such accumulations essential for Social Security purposes. The important issues related to reserve financing have less to do with Social Security than with value judgments about the relative weight to be given the interests of future residents of the United States as compared to those living today or the current interests of young workers over the next 40 years versus their interests when they retire.

Social Security will work either way, as a "pay as you go" system based on an intergenerational compact, with the retirement benefits of each generation paid by the one that follows, or it can be designed—and I think it is superior to so design it—as a partly funded system in which each generation comes close to paying its own way.

I hope that if we continue the present course the preference for a big buildup does not lead the public to believe that it is essential. My main reservation about continuing the present course—and I do favor it—is that it would be too bad, for example, to have public faith in Social Security damaged if in the mid-1990's Congress decided to shift part of the contribution rate from OASDI over to the Medicare program, which is underfunded. That might happen, and if it did, of course, it would move OASDI back toward a "pay as you go" system.

The loss in such a move, as compared to providing the additional Medicare funding that would otherwise be needed, would be a somewhat lower gross national product down the road and somewhat higher contribution rates for both OASDI and Medicare. Social Security could still pay benefits as they fall due, although, as I said earlier, I believe the benefit structure is even more secure under a partly funded system.

The final point that I would like to make, Mr. Chairman, is that there is no hurry to make these decisions. The policy to be followed is very much the same for the next several years whether one elects for a partly funded system or a "pay as you go" system.

In any event, we need to bring down the non-Social Security deficit. In any event, Social Security funds need to be built up to reach even adequate contingency reserves. At the present time, in spite of all the talk about growing reserves in Social Security, you should remember that is mostly in the future. At the present time the reserves amount to only 50 percent of the next year's outgo. It will be nearly to the mid-1990's before Social Security reaches even an adequate contingency reserve for a "pay as you go" system.

So I see no need to rush this decision. The advice of the about-to-be-appointed statutory advisory council by the Secretary of Health and Human Services can be sought, and the Congress can take their advice into account, study these matters at leisure and make its decision in an unhurried fashion.

Thank you.

[The prepared statement of Mr. Ball follows:]

PREPARED STATEMENT OF ROBERT M. BALL

The Social Security Trust Fund Surplus

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE;

My name is Robert Ball. I was Commissioner of Social Security from 1962 to 1973. Prior to my appointment by President Kennedy I was a civil service employee of the Social Security Administration for some twenty years. Since leaving the government in 1973, I have continued to write and speak about Social Security and related programs. I was a member of the 1978-79 Advisory Council on Social Security and more recently was a member of the National Commission on Social Security Reform, the Greenspan Commission, whose recommendations were included in the 1983 Amendments. I am testifying today as an individual and the views expressed are not necessarily those of any organization with which I am associated.

THE BUILD-UP OF THE TRUST FUNDS

Mr. Chairman, there have been big changes in Social Security financing since the 1983 Amendments. The trust funds are building at an astounding rate. In this calendar year Old-Age, Survivors and Disability Insurance (OASDI) income is expected to be $294.2 billion and outgo $235.7 for a gain in this one year of $58.5 billion. This increase takes the OASDI trust funds from a level of $109.8 billion at the end of 1988 to $168.3 billion at the end of 1989. And the funds are expected to keep growing for the next 40 years.

The annual surplus will be nearly $70 billion next year, nearly $100 billion in 1993, $125 billion in 1995 and $170 billion for the one year 1998, bringing the OASDI trust funds by that time to $1,194 million.

Now in spite of these encouraging estimates--and of course that is what they are, estimates--we are not yet at what most experts would consider an adequate contingency level for the long run--that is, enough to carry the system through a bad economic period of, say, back-to-back recessions as in the late 1970's and early 1980's. Such a contingency fund should ordinarily be from 100% to 150% of the next year's outgo. Assets are now equal to about 50% of the next year's outgo and will reach the 100% to 150% level in the period 1992-94.

From the mid-1990's on, Social Security will be building a fund beyond a contingency level and start to develop a sizable earnings reserve. Under the 1989 middle-range II-B projections of the Board of Trustees, about 2030 the funds reach $12 trillion (over $2 trillion in today's dollars). We can be quite confident that present financing will carry the OASDI program for at least the next fifty years and probably longer.

How did we get to this enviable position after all the talk of impending bankruptcy in 1981 and 1982? First of all the bankruptcy talk was always an exaggeration. There was a short-term financial problem in the early eighties, but we knew then that during the

1990's and for some time beyond, Social Security would be in good shape. This is true because demography is now favorable to Social Security. The rate of increase in the elderly population is slowing down for awhile because of the low birth rates in the depression years, and when combined with the increase in the number of workers because of the baby-boom, the ratio of workers to retirees does not change very much for many years. Thus any increase in productivity reduces the cost of the program relative to the payrolls on which most of the financing is based.

Secondly, benefits were cut back somewhat by the 1983 amendments and the economy has performed better than projected at the time of the amendments. The result is that the cost of Social Security has not been going up as a percent of payrolls, which is the impression many have, but has been dropping dramatically. For example, in 1982, the cost of OASDI was 11.95% of covered payrolls. This year it is expected to be 10.36% of payroll, a 13% decline in costs in seven years. The cost is projected to decline further to 10.27% by 2000 before climbing moderately to 10.76% by 2010 and then to 12.03% by 2015, roughly the 1982 level. The very large annual surpluses are developing because the 1977 Amendments increased the contribution rate for 1990 just as the costs measured as a percent of payroll are dropping and the 1983 amendments moved most of the 1990 rate increase to 1988. The combined rate for employers and employees went to 12.12 for OASDI in 1988, and will go to 12.4 in 1990. No further increases are scheduled.

Throughout the next 25-year period and somewhat beyond, this combined contribution rate of 12.4% will be producing income much greater than the cost of benefits. Moreover the annual surpluses will be even larger than shown by a comparison of costs and contribution rates because the income derived from taxing 50% of the benefits of higher-income beneficiaries is returned to the trust funds, and interest is earned on the reserves as they build.

In order to pay full benefits after the peak build-up is reached about 2030, it will be necessary to start cashing in trust fund bonds. This source of financing added to contribution income, the taxation of benefits of upper-income beneficiaries, and interest earnings will fully finance the program for approximately 15 years more. It is thus entirely correct to say that the OASDI program is in good financial shape, with costs that should be manageable not only in the near term but for a very long time before it may become necessary to raise the contribution rate above the 6.2% rate scheduled for next year.

The cost of hospital insurance (HI), on the other hand, has been rising both in absolute and relative terms. It reached 2.53% of covered payrolls in 1987 and the II-B projections show costs reaching 3.42% in the year 2000 and 3.96% in 2010. That is substantially higher than the combined employer-employee contribution rate of 2.90%, the rate now being charged and the maximum scheduled under present law. In their 1988 report,[1] the Social Security trustees estimated that HI reserves, including interest earnings, will continue to build only until 1997 and will then decline, with the system requiring additional financing early in the next century. Exactly how much and how soon will depend on a number of variables, including the impact of research on the diseases associated with aging, other disease-prevention measures, the impact of new medical procedures on costs and the effectiveness of cost-containment efforts. But there can be little doubt that the HI program will require additional funding. According to the 1988 report, 25 years from now assuming present trends and no major breakthroughs in cost-reducing research, the employee and employer contribution rate needed to sustain the program could be as much as 2.2% of earnings each, compared to the current 1.45%, with further increases necessary later.

Medicare Part B, covering mainly physicians' charges is technically not under financed (since about three-fourths of the cost is funded through general revenues and more of those revenues, it is assumed, will be directed to the program as costs rise)

[1] See Endnotes.

but it is increasingly burdensome both to taxpayers generally and to those covered by the program who must pay more and more in premiums to help cover program costs. The Medicare program now also includes catastrophic protection which is intended to be fully financed by an increased premium paid by all elderly and disabled beneficiaries and by a supplementary income-related premium to be paid by about 40% of those beneficiaries.

We have then an old-age, survivors and disability insurance program that is adequately financed on a partial reserve basis for several decades into the next century and a Medicare program that in all probability is likely to turn out to be under financed in the very early part of the next century.

WHAT ARE THE POLICY OPTIONS FOR DEALING WITH SOCIAL SECURITY FINANCING AND THE PROJECTED BUILD-UP IN THE RESERVES?

1. There are differences of opinion among experts about whether we should accumulate large Social Security reserves as provided by present law, but I believe there is widespread agreement that if we do, they should not simply substitute for general taxes and be used to pay for the current operating expenses of the federal government. Most would argue that any sizable build-up in reserves is justified only if they increase investment, and thus by enlarging the future pool of goods and services make it easier to support future Social Security beneficiaries. I know of no one

who favors over the long run the present practice of using the Social Security surpluses to pay the government's current operating bills.

2. The desired result of having the Social Security surpluses contribute to investment can be achieved by bringing the non-Social Security budget down to approximate balance so that the Social Security surpluses then buy up existing government debt and release private funds for investment in private industry.

There is another possibility. Not all federal expenditures are current consumption. Some are important investments in the future--health care for children and pregnant women, roads, bridges, education, job training and so on. If we could carefully define what are federal investments and use Social Security reserves to increase what is going into these investments, a higher volume of goods and services in the future would result as surely as freeing up funds for private investment.

3. At present Social Security has been taken out of the unified budget by basic law, but the Gramm/Rudman/Hollings amendment put the annual surpluses back in for the purpose of deficit reduction targets. I believe it would be easier to prevent the use of the Social Security surpluses for current operating expenses if we were to stop counting the surpluses for deficit reduction purposes. Making this change would focus attention on reducing the non-Social Security deficit.

Although I believe it is highly desirable to completely remove Social Security from the deficit targets, I would not recommend doing so immediately or all at once. It is going to be difficult enough to bring the unified budget, including Social Security, down to the deficit targets. To remove Social Security annual surpluses from the targets now would result in great pressure to cut programs which should not be cut and would make it even more difficult to spend additional money where it should be spent. I would propose, rather, that we run out the Gramm/Rudman/Hollings targets with the present accounting, and then gradually reduce the non-Social Security deficit.

4. The final goal I would favor would be either to reduce the non-Social Security deficit to approximately zero so that the Social Security surpluses represented a surplus in the unified budget which would be used to buy back existing debt and result in greater private investment, or, alternatively, the deficit for non-Social Security operating expenses could be eliminated but government investment could be allowed to grow. The growth in Social Security reserves could be the source for these additional government investments. The difficulty with this latter course is in knowing where to draw the line. Some government investments are clear-cut but other expenditures have some of the characteristics of both current consumption and investment.

5. I believe that the policy that I have described is the best policy for America's future, but I also believe it is the best

policy from the narrower perspective of Social Security. I believe that the stability of the Social Security benefit structure will be enhanced by a policy that uses Social Security reserves to increase the total volume of goods and services in the future. The support of the retirees of the baby-boom generation will be easier if the total volume of production is greater than it would otherwise be, and the payment of promised benefits will be more secure the easier it is to make those payments. Moreover, it seems to me that to the extent it can be shown that the current generation is paying for its own consumption and, in addition, is saving for its future retirement, the more certain it is that the Social Security promises made to that generation will be honored.

6. I believe one change should be made in the present design of Social Security financing. The present plan of a big build-up in reserves and then a dissipation of the reserves might make sense if the retirement cost of the baby-boom generation was a one-time cost followed by a lower continuing cost--a sort of rabbit through the Python phenomenon--but such is not the situation. Instead the baby-boom retirees establish a new plateau of cost which stays more or less level on into the future. This is because fertility rates are expected to remain low--holding down the size of the workforce--and mortality rates are expected to continue to improve so that retirees will live longer.

If we are going to build this reserve as called for by present law, I believe we ought to maintain it. One way to do this is to schedule a tax rate increase around, say, 2030 of about one percentage point for employees and the same for employers. Under this plan, the reserves continue to increase in nominal terms but they drop relative to benefit payments. At the end of the 75 years over which the estimates are usually made, the reserve equals about one or one-and-a-half times the next year's outgo, a reasonable contingency reserve. Social Security could then continue on a pay-as-you-go basis with relatively level costs, but we would have had the advantage of two generations of increased savings, while avoiding after 2030 the need to increase general taxes to redeem the bonds held by the Social Security trust funds. The bonds would instead be a permanent income-producing resource for Social Security, with general revenues paying interest for the use of the money, it is true, but no greater than would be required for the same amount of borrowing from private sources.

7. I want to be very clear that although I see advantages for Social Security in large trust fund accumulations and even more advantages for the future economy, I certainly do not consider such accumulations essential for Social Security purposes. The important issues related to reserve financing have less to do with Social Security than with value judgments about the relative weight to be given the interests of future residents of the United States

as compared to those alive today, or the current interests of young workers over the next forty years versus their interests when they retire.

Social Security will work either as a partially funded system or as a pay-as-you-go system. It can be designed as a pay-as-you-go system built on an intergenerational compact, with the retirement benefits of each generation paid by the one that follows, or it can be designed as a partly funded system in which each generation comes closer to paying its own way.

I hope that a preference for building Social Security funds and then maintaining them does not lead the public to believe that the future reliability of the system depends on such a plan. That is my main reservation about continuing down the road of a partially funded system. It would be too bad, for example, to have public faith in Social Security damaged if in the mid-1990's Congress decided to shift part of the contribution rate from OASDI to the under funded Medicare program, an action which would move the OASDI fund back toward pay-as-you-go. The loss in such a move, as compared to the additional Medicare funding that would otherwise be needed at some point, would be a somewhat lower gross national product in the future (and a somewhat higher contribution rate for the OASDI program around 2025 or 2030), but it would work. Social Security could still pay benefits as they fall due; although, as I said earlier, I believe the benefit structure is even more secure under a partly-funded system.[2]

8. **In summary,** I believe the most desirable policy is to continue to build a large surplus, to maintain it by a contribution rate increase around 2030, to gradually take Social Security out of deficit targets beginning in 1993, and either bring the non-Social Security deficit down to approximately zero or bring the current operating expense part of the federal budget to zero with Social Security surpluses increasing government investments that promote future productivity increases.

My very last choice would be to continue indefinitely as we are. If we don't use the Social Security surpluses for investment in the future, I would favor returning to a pay-as-you-go policy with a contingency reserve equal to about one-and-a-half times the next year's outgo. If this were the policy choice, I would not reduce Social Security contributions overall, but rather, once an adequate contingency reserve is reached for OASDI, I would favor shifting part of the OASDI rate to Medicare, which for the long run is substantially under financed.

9. There is no hurry about deciding any of this. I believe the right course for the next few years is the same regardless of a decision about an earnings reserve for Social Security. The deficit in the unified budget should be reduced in any event, and the OASDI trust funds should be allowed to grow until they reach an

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[2] See Endnotes.

adequate contingency level of, say, 150% of the next year's outgo, a level which is not projected to occur until 1993 or 1994.

All the possibilities should be studied and reported on by the statutory Advisory Council to be appointed soon by the Secretary of Health and Human Services, including the possibility of keeping OASDI more or less on a pay-as-you-go basis and shifting part of the OASDI contribution rate to Medicare. Such a shift would result in both OASDI and Medicare being adequately financed for well over the next 25 years without any increase in the combined OASDI and HI contribution rates, although a somewhat higher rate than presently scheduled would be required for both programs later on. The Congress can take its time to make these decisions. There is no good reason to hurry.

Mr. Chairman, thank you for the opportunity to testify on this important subject.

ENDNOTES

1. Although the 1989 trustee reports for OASDI and Supplementary Medical Insurance have been issued, the Hospital Insurance report has not yet been released.

2. The issue of partial reserve financing versus pay-as-you-go has been with us since the very early days of Social Security. What we had up until the legislation of 1972 was a more or less pay-as-you-go system in practice and a partial earnings reserve in theory. There were always contribution rates in the law scheduled to take effect later, which, if they had been allowed to go into effect, would have built big reserves. However, whenever the Congress got near the time an increase in rates would have produced reserves beyond those needed to cover short-term unexpected economic downturns--contingency reserves--the increases were postponed. Nevertheless, the system was always balanced in the long-range actuarial estimates by taking into account the increases scheduled for the future.

In 1977, the system was under financed. To help meet the long-range cost the rate increase scheduled for 2011 was moved up to 1990 even though it was recognized that the cost of the program would be relatively low in the 1990's. That change made building a sizable reserve a near-term possibility. The 1983 Amendments kept the 1990 rate and moved most of it up to 1988.

When the 1988 rate went into effect, for the first time the system in actual practice shifted from pay-as-you-go to partial reserve funding.

The question has been raised frequently whether the National Commission on Social Security Reform, whose recommendations formed the basis of the 1983 Amendments, deliberately planned a shift from pay-as-you-go to partial reserve financing. It is not clear to what extent individual members of the Commission favored moving in such a direction, but the issue as such was not discussed by the Commission. The concern of the Commission was first to make absolutely sure that the short-term financing problem was solved--that the system was adequately financed on the basis of conservative assumptions at least through the 1990's. Secondly, as its report clearly shows, the Commission was concerned that OASDI financing be adequate over the whole 75 years for which the estimates are made. To move as far as possible toward agreement for both the short- and long-term, the Commissioners accepted all the financing provided by the law then in effect, including the 1990 rate increase, and then recommended ways to improve the financial position of the program.

The Commission members recognized that if they cut back on the 1990 rate increase, even temporarily, that more financing would be required later; given the size of the Social Security financing problem, no one favored giving up any financing already in the law. As has been pointed out, the result of the 1988 and 1990 increases will be a large reserve build-up and than a later dissipation of that reserve, but the Commission did not explicitly address the desirability of that result.

Representative HAMILTON. Thank you, Mr. Ball.

Ms. Sawhill, please proceed.

STATEMENT OF ISABEL V. SAWHILL, SENIOR FELLOW, THE URBAN INSTITUTE

Ms. SAWHILL. Thank you, Mr. Chairman. I listened with great interest to Mr. Ball's testimony and find that I agree with much of it.

I will also skip over the points in my prepared statement about the accumulation of sizable surpluses over the next 40 years, followed by substantial deficits thereafter, as I think the magnitude of the buildup and other dimensions of the issue are well known by now.

The point that I do want to emphasize, however, in my oral remarks is that no matter how we treat these surpluses taxes are going to have to be raised or benefits reduced to pay for the baby boom's retirement.

I mention this because I think there is so much misunderstanding about it. It is a mistake to think, as many do, that the money accumlated during the surplus years can be squirreled away and drawn down during the years after 2030 to cover the deficits occasioned by the baby boom's retirement.

The trust fund's assets consist of Treasury securities, which are no more than paper IOU's, representing, to be sure, a moral claim on the rest of government and on its tax levying authority, but those securities or that moral claim will have to be exercised by raising taxes after 2030 if current benefits are going to be maintained. It won't necessarily be payroll taxes that have to be increased. It could be income taxes. But the revenues will have to be found somewhere.

I don't totally agree in this context with Mr. Ball's argument that we don't need to worry about this too much in the next 4 or 5 years. I think it is important that we think now about how we are going to pay for the baby boom's retirement, whether through higher revenues or through some reduction of other government spending or a reduction in benefits, perhaps by stretching out the retirement age further or by taxing Social Security benefits, or what have you. The reason it is important to make those decisions soon is because it is only fair to give people a long period of time to plan for any changes in policy that might be made.

There are three major options, it seems to me, for dealing with the accumulating surpluses. The first is to continue the Gramm-Rudman policy of seeking balance in the unified budget, inclusive of Social Security. I think that goal has considerable merit, especially if we could actually achieve it as opposed to just talking about it and especially if one were comfortable with the current distribution of income both between and within generations; in other words, with the heavy reliance on payroll taxes in our overall revenue portfolio right now and with the fact that, because we are running deficits, we are not saving for the future.

The second option is to put Social Security off budget for deficit reduction purposes and to seek to balance the budget without the help of the Social Security surplus. I think this option has merit if one believes we should tighten our belts now in order to save more and to provide more adequately for our children and our grandchildren, as Mr. Ball has indicated.

The third option is to reduce payroll taxes so that the surpluses don't accumulate in the first place, an option that has merit if one can find another source of revenue to replace the foregone payroll taxes. However, I think that given the popularity of the payroll tax and the unpopularity of income taxes, it is probably not politically feasible to do that, although there could be an argument for moving in that direction over the longer run.

My most important point, I think, is that the unified budget, inclusive of Social Security, is the appropriate measure of the Government's final position, and this is a point that needs to be made in connection with option 1 as well.

Credit markets and the economy after all don't really care where revenues come from or how money is spent. It is the overall deficit or surplus in the Government's budget, inclusive of Social Security that is the best measure of the budget's effects on the economy. The real issue then is do we want to use the opportunity created by favorable demographic trends over the next 20 years to save and invest more as a nation?

I think the answer is ultimately a political decision, which depends upon one's view of intergenerational equity. However, there are good arguments for moving in that direction, at least after 1993, or whenever the Gramm-Rudman targets are met, and here I very much agree with everything that Mr. Ball said.

The argument is not only that this would provide more wherewithal to help out with the payment of the cost of the baby boom's retirement, but it would also make us more competitive internationally and raise standards of living, all of which I think are desirable. In this connection, like Mr. Ball, I favor both more private and more public investment. The former can be accomplished, as he noted, by running a surplus in the unified budget so that some debt can be retired and downward pressure put on interest rates, and the latter can be accomplished by devoting a larger share of total Federal expenditures to human resource investment, R&D and infrastructure.

I think it would take great political discipline, however, to accomplish these goals, and I am not terribly optimistic about our ability to use the Social Security surpluses for this purpose.

Another likely outcome is that the surpluses will be tapped to pay for more generous benefits for the elderly, perhaps to fund long-term care, or eliminate the earnings test in Social Security or other policies of that sort, and given the political difficulty of setting these surpluses aside for the purposes of accomplishing both more public and private investment, I think a reasonable fallback position would be simply to try to balance the unified budget, inclusive of Social Security, as a reasonable long-term goal.

Thank you.

[The prepared statement of Ms. Sawhill follows:]

PREPARED STATEMENT OF ISABEL V. SAWHILL

The Social Security Surplus: An Opportunity To Invest in the Future

SUMMARY OF TESTIMONY

1. The Social Security system will accumulate sizeable surpluses over the next 40 years followed by substantial deficits thereafter.
2. No matter how we treat these surpluses, taxes will have to be raised or benefits reduced to pay for the baby boom's retirement.
3. There are three major options for dealing with the accumulating surpluses. The first is to continue the Gramm-Rudman policy of seeking balance in the unified budget, inclusive of Social Security. The second is to put Social Security "off budget" and to seek to balance the budget without the help of the Social Security surplus. The third is to reduce payroll taxes so that the surpluses don't accumulate in the first place. Each of these options has advantages and disadvantages that are spelled out in my testimony.
4. My own view is that between now and 1993 it will not be feasible to put Social Security off budget because of the enormous fiscal stringency that this would imply. But after 1993, assuming the Gramm-Rudman targets have been met, I favor using any further increase in the surplus for public and private investment.
5. Specifically, half of the increase in the surplus after 1993 could be used for private investment and half could be used for qualified public investments on the grounds that the two are complementary means of increasing the rate of economic growth and providing the wherewithal to pay for the baby boom's retirement.

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BACKGROUND

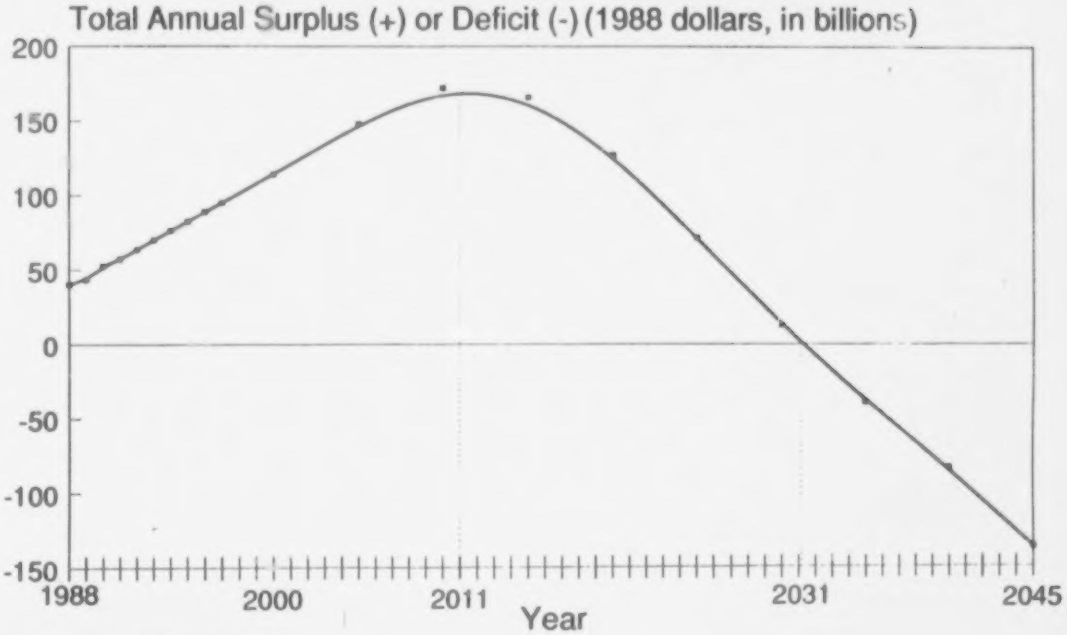
When the original Social Security legislation was passed in 1935, some thought was given to making it at least a partially funded system. In practice, however, the system has always operated more or less as a pay-as-you-go system with today's workers paying for today's retirees rather than funding their own future retirement. In 1983, when it appeared that the system would not have enough revenues to pay even next year's benefits, a bipartisan commission, headed by Alan Greenspan, was formed to restore the financial integrity of the system. The Commission called for a series of payroll tax increases and benefit reductions that not only solved the short-run financial problems of the system but also created, as a by-product, a series of annual surpluses from now until about 2030.

These surpluses are displayed in Chart 1. The projections shown in the chart are based on a set of economic and demographic assumptions that I won't belabor except to emphasize that it is demographic trends that are driving the story. The size of the working-age population relative to the elderly population is quite favorable up until about 2010 and then levels off as the baby boom retires. The specific projections shown in Chart 1 could, of course, be wrong but no matter how one looks at it, we are talking about large amounts of money with potentially large effects on the economy and on financial markets.

Before we address these effects, I want to dispel a myth that I think has done more than anything else to confuse discussions of this issue. I call it the money-under-the-mattress myth. Most people look at a chart like Chart 1 and assume that money accumulated during the surplus years can be squirreled away and drawn down during the years after 2030 to cover the deficits occasioned by the baby boom's retirement. But that view is, I think, very misleading. Chart 2 reviews how the system actually works and why there will be no money under the mattress when the baby boom finally retires.

Chart 1

Social Security Surpluses



Source: 1988 Annual Report of the Board
of Trustees of OASDI, Alternative II-B
Projections, Table 6-1, p. 141

CHART 2

FOLLOW THE MONEY

Between Now and 2030: All the Money is Spent

1. Each year's surplus is invested in Treasury securities

2. The money is spent

   (a) for current government expenditures

   (b) to retire debt

   (c) to reduce taxes

After 2030: There is No Money under the Mattress

3. The Social Security deficit is covered by asking the Treasury to redeem the Trust Fund's securities

4. The money must come from

   (a) increasing taxes

   (b) issuing new debt

   (c) cutting government expenditures

The key to understanding this point is to remember that each year's surplus is spent either by the government or (if taxes or debt are reduced) by the private sector. The trust fund ends up, not with real resources, but with paper IOUs in the form of Treasury securities. In order to redeem these securities when the baby boom retires, the Treasury will need to raise taxes. (If it simply sells the securities to the public to raise the necessary funds, we will be faced again with large budget deficits.)

The bottom line is that, regardless of how we treat the surpluses, the nation needs to think now about how it's going to fund Social Security benefits for people who are currently in their 30s or 40s. The baby boom is either going to have to accept lower benefits--perhaps by working longer--or their children will have to pay higher taxes. In order to preserve current benefits for both Social Security and Medicare, it's estimated that payroll taxes will have to be increased by about 7 percentage points between 1990 and the middle of the next century. Whichever the choice--higher taxes or lower benefits--the issue should be resolved soon so that there will be plenty of time for people to adjust to any change in policy.

THE OPTIONS

Even though there is no money under the matters, it matters what happens to the surplus between now and the next century. How it is treated will affect the rate of economic growth, the size of the public sector, and the distribution of income between and within generations. I see essentially three options for dealing with the surpluses as summarized in Chart 3.

OPTION ONE is to continue to do what we are doing now which is to use the surpluses to finance deficits in the non-Social Security portion of the budget. This means using payroll taxes to pay for everything from the President's salary to MX missiles.

OPTION TWO is to (somehow or other) balance the budget without the help of the Social Security surplus and then to use the surplus for either private or public investment. If the surpluses are saved and invested, the nation will have higher productivity and higher incomes in the next century and this could help to offset the higher costs of supporting a larger population of

Chart 3

WHAT TO DO WITH THE SOCIAL SECURITY SURPLUSES: OPTIONS FOR A NEW PRESIDENT AND CONGRESS

Option 1: CURRENT POLICY

Use the surplus to finance existing deficits

Option 2: INCREASE INVESTMENT

Balance the budget without the surplus and use it for investment in

(a) the private sector (by retiring debt)

(b) the public sector (by spending more on human resources, research, or infrastructure)

Option 3: REDUCE PAYROLL TAXES

Balance the budget without the surplus and then reduce payroll taxes so no more surpluses accumulate retirees. This fact has led a number of prominent economists to support this option. In fact, a recent Brookings book, lays out this option in some detail.[1]

OPTION THREE is to reduce payroll taxes so that surpluses don't accumulate and thus can't be used to finance existing deficits or anything else. This option has been put forward most cogently by Robert Meyers, the former actuary of the SSA and Executive Director of the Greenspan Commission.

I want to emphasize that options 2 and 3 both involve finding some other way to reduce existing deficits, thereby freeing up the surpluses to be used either to increase investment or reduce taxes. I doubt that this is going to be politically feasible over the next few years. The reason is that the President and the Congress would need to find an extra $100 billion of budgetary savings beyond those necessitated by the Gramm-Rudman targets if the surpluses were not available to offset deficits in the rest of the budget.

But these other options are still relevant for the longer run. Recall that the Social Security surpluses keep growing at least until 2010 and that they are sizeable (reaching $173 billion in 1988 dollars by 2010). The issue is whether the nation wants to continue the practice of funding operating deficits with Social Security surpluses over this longer time period.

EVALUATING THE OPTIONS FOR THE LONGER RUN

I now want to take a closer look at each of the three options. They can be evaluated on the basis of their effects on the distribution of income within and between generations.

Option One: Maintaining Current Policy. Our current policy of treating the Social Security surplus as part of the regular budget has much to recommend it. One can argue that segregating and earmarking revenue sources is a silly and pernicious thing to do. A dollar of revenue is a dollar of revenue wherever it comes from and the unified budget is the right way to look at the government's fiscal position. Credit markets couldn't care less about what the government is spending its money on, only about its total borrowing needs. And a reasonable, and well-understood target, for the unified budget deficit is to get it down to zero so that the government is neither subtracting from, or adding to, the economy's overall levels of savings and credit.

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[1] Henry J. Aaron, Barry P. Bosworth, and Gary Burtless, Can America Afford to Grow Old?, Brookings Institution, Washington, D.C., 1989.

On the other hand, one can argue that the public supports the payroll tax because they think it is earmarked, and that it is a breach of faith to use it for other purposes. And even if it weren't a breach of faith, it's troubling to think of financing a growing proportion of all government expenditures with a regressive tax. More than one-third of all federal revenues now come from payroll taxes, and these take an absolutely bigger bite out of the incomes of middle class families than do income taxes. And the relative growth of payroll taxes in recent years has caused the overall tax system to become increasingly less progressive in its effects.

Option Two: Investing the Surplus. The major argument here is that the availability of the surpluses creates an opportunity to increase investment. There are two ways to do this. One is to use the surpluses to retire outstanding debt, so that there will be a larger supply of credit in the private sector, lower interest rates, more business fixed investment, and a faster rate of economic growth. Alternatively, one could invest the surpluses in such things as education, training, research, and public infrastructure, on the assumption that these, too, are important to the future productivity of the economy and the ability of the next generation of workers to earn the kind of incomes that will be needed to pay for their parents' rather expensive retirement.

The analogy is with a funded pension system in which today's contributions are invested in a way that assures some real return in the future. And this approach would appear to mesh well with the public's desire to think of Social Security as a collectively funded system--which it is not right now.

There are, however, some problems with Option Two. First, encouraging more investment by running a surplus in the unified budget means higher taxes or lower spending elsewhere in the budget. Put differently, the current generation would have to accept a lower standard of living in order for their children to be better off. But as long as there is any economic growth at all--for any reason--children are going to be richer than their parents--and making life still better for the next generation is not everyone's idea of intergenerational equity.

Second, this option might not have all of the intended effects. Assuming we run a surplus in the unified budget in an attempt to encourage private investment, the expected drop in interest rates might not occur if the extra capital simply flowed out of the country, if unproductive investments were made, or if the fiscal restraint associated with the surpluses slowed the growth of the economy for old-fashioned Keynesian reasons. Assuming the emphasis was placed on more public investment, there might be a tendency for Congress to define a large proportion of questionable outlays as investment, and certainly not everything that was tried, programmatically, would be effective in raising future productivity.

Option Three: Reducing Payroll Taxes. The proposal here is to reduce or cancel scheduled increases in the payroll (OASDI) tax to the point where there will be a contingency reserve equal to one year's benefits but no surpluses beyond that.

The arguments in favor of this proposal are that:

- It removes the temptation to use the projected surpluses to expand programs for the elderly. If the surpluses are allowed to build, they are a logical source of funding for long-term care, and one can imagine the elderly mounting a highly successful campaign to earmark them for this purpose. But any such expansion of benefits for the elderly would simply exacerbate the long-run financial difficulties that I alluded to earlier.
- It is simple and straightforward because it puts the system back on a pay-as-you-go basis.
- If combined with an increase in income taxes, it would create a fairer system of government finance.

The big argument against this option is that the payroll tax is a relatively popular tax and that it is producing a lot of needed revenues. Moreover, to reduce taxes further at this point is, at bottom, a vote in favor of more private consumption as against more publicly-financed consumption ~~or~~ more public or private investment. And, like Option One, it would not prepare us for the real economic burdens associated with the baby boom's retirement.

CONCLUSIONS AND A PROPOSAL

My own view is that Option One is what we will have to live with in the short run and that it is not such a bad option, even on the merits of the case. Its advantage is that it treats all spending and tax decisions in one unified framework. Each program or source of tax revenue has to compete with every other program or source of revenue on the usual grounds of efficiency, growth, and fairness. Moreover, it in no way forecloses the possibility of running surpluses if more public savings is what is desired. It simply decouples this decision from the size of the Social Security surplus. Put differently, more investment is desirable for lots of reasons that have nothing to do with the retirement of the baby boom.

Option Two's real purpose is to increase the rate of economic growth. The demographic swings that are causing the trust fund build-up and subsequent depletion are simply one rationale for a more investment-oriented policy. With respect to the kinds of investments that are needed, I have seen no evidence that would allow us to make a firm judgment on the relative payoffs from more public vs. more private investment. An extra dollar invested in prenatal care may be just as productivity-enhancing as an extra dollar spent on plant and equipment. A sensible strategy might be to have some more of each. Thus I would favor some surplus in the unified budget deficit, if we can get it, but also much more focus on such things as early childhood nutrition and health care, preschool education, training, drug abuse programs, and other public investments that have a reasonable chance of making the next generation more productive.

These arguments suggest a specific strategy that might be implemented once the Gramm-Rudman targets have been achieved. The proposal would be to use half of the continuing buildup in the trust fund after 1993 for qualified public investment and half for private investment. The first would be accomplished by spending more on human resource programs, research, and infrastructure and the second by running small surpluses in the federal budget so that some of the government's debt could be retired.

It should be noted that, even if the Gramm-Rudman targets are met, roughly $100 billion of the Social Security surplus will still be devoted to covering deficits in the government's other program accounts after 1993. This contribution could conceivably be thought of as supporting the investment component of those other programs. The argument would be that the nonsocial security deficit would be matched by a roughly equivalent amount of public outlays for infrastructure, research, and human capital. According to the Office of Management and Budget, federal investment outlays for such nondefense purposes totaled $73 billion in 1988 [Office of Management and Budget, 1989d: D-3]. If these investment outlays grow with inflation, they will be roughly comparable to the Social Security Trust Fund's contribution to regular government outlays in 1993.

However, since annual surpluses continue to grow above $100 billion a year after 1993 (peaking at $172 billion in 1988 dollars in 2010), substantial sums would still be available for new investments under this proposal. Specifically, a total of $500 billion could be devoted to such purposes between 1994 and 2005--assuming current projections of the size of the surplus prove realistic.[2] An average of $21 billion a year would be available for new public investments and a comparable amount for new private investments. The risk is not that there would be insufficient resources but that they would be spent unwisely. For this reason, Congress needs to think carefully about what kinds of spending might qualify as public investments and needs to resist political pressures to use a very broad definition. One option would be to require that the productivity-enhancing capacities of any new or existing program be independently and carefully evaluated before it could qualify for funding from the Social Security Trust Fund surplus. Whether adequate discipline can be incorporated through this or some other means remains a question mark. However, if money from the increasing Social Security surpluses is allocated wisely, it clearly has the potential to increase national productivity and living standards and to provide some of the wherewithal out of which to fund the baby boom's retirement.

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[2] Author's calculations using "Alternative II-B", 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (May 1988). Also, see Jason Juffras and Isabel V. Sawhill, "Financing Human Capital," in David W. Hombeck and Lester M. Salamon, editors, Investing in People: An Economic Strategy for the Nineties, forthcoming.

Representative HAMILTON. Thank you, Ms. Sawhill.

Mr. Makin, please proceed.

STATEMENT OF JOHN H. MAKIN, DIRECTOR, FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. MAKIN. Thank you, Mr. Chairman.

I have a longer statement that has been prepared for the record, but let me just summarize some of the high points.

I have found the trust fund surplus very stimulating and it has led me to perhaps question some of the conventional wisdom about saving and intergenerational issues.

I think it is important to realize that based on what economists know about saving and investment and its effect on growth, the notion that the trust fund surplus is going to necessarily affect the saving rate one way or the other and thereby lead to faster growth is really a fanciful notion. It is very difficult to separate the effect of a change in payroll tax contributions to Social Security and to analyze its effect on private saving. It is a controversial area, and at this point I think we know we don't know enough about the effects of Social Security on private saving to assess whether or not the trust fund surplus indicates anything about the current or the prospective national saving rate.

Second, we have to ask ourselves some very basic questions as we contemplate the trust fund surplus or any measure that is meant to accumulate assets to be spent in the future. We need to determine what is or what would be the optimal saving rate for the Nation.

I think there is a temptation for individuals or for people to say that whatever the optimal rate may be, it is higher than the saving rate we have now. That is not at all clear. It is a tempting notion, but it is not at all clear. The fact that participation in the Social Security system through a compulsory payroll tax alters the behavior of individuals is certainly something we should take note of. I will try to mention a couple of other instances that I think suggest possible damage to economic performance.

But here again there is no guarantee that a $12 trillion trust fund surplus necessarily means that the saving rate will be higher or lower, and given that the saving rate is higher or lower, there is no guarantee of better economic performance. I would challenge anyone who asserts otherwise to present consistent, solid evidence that that is the case.

I invite people to read my prepared statement carefully because I end up with a conclusion which appears a little bit heretical. I conclude that we should phase out the system as it currently exists and go to a negative income tax to fund a safety net program for the elderly.

The system was originally conceived in the 1930's, I believe, out of concern, a legitimate concern, for the status of Americans who have retired, who are over 65 or over some age. We wanted to be sure that these individuals did not live in poverty. It strikes me that if that is the case, that it would make a great deal more sense simply to have a negative income tax that says if you are over age *x*—and we pick the age, be it 65 or 67—and your income is below *y*, where *y* is some number, either at the poverty line or at 110 or 120 percent of the poverty line, the Federal Government sends you a check for the difference.

Now, that approach is a good deal less expensive than the current system. I calculated it in 1985. If you made all the generous assumptions maximizing costs and you wanted to make sure that no one over age 65 had an income below the poverty line; that is, you would simply fund out of general revenues a transfer to any individual who did, the cost would be approximately one-fifth, 20 percent, of the outlays of the Social Security system.

The reason for that tremendous difference is, of course, the fact that many of the benefits represent an intergenerational transfer from young workers to retired individuals. It is also a reflection of the simple fact that since 1983 the per capita income of the retired population; that is, the population over age 65—I don't necessarily mean retired, but the population over age 65—is higher than the per capita income of the working age population.

Now, against the background of that fact, I guess I raise in my own mind some serious questions about a system that currently is designed to transfer resources from a working age population to a retired population where the per capita income of the retired population is higher than the working age population.

The financing vehicle is also very problematic. Even if we agreed that this is the system we want, that we want to keep the Social Security system in place, the payroll tax is a terrible method to finance it. I find it remarkable that people who consider themselves more concerned about social justice think that the payroll tax, which is a regressive tax, is a good way to finance a system to transfer resources to relatively well to do elderly individuals. If we were going to design the system, why would we do it that way?

Second, the payroll tax represents a heavy tax on the use of labor, especially raw labor. If you are going to say to an employer the act of hiring someone will imply that you pay a 15-percent tax, then the employer is going to say well, how can I employ less individuals? There are a number of answers.

Employers will substitute machinery for labor wherever they can. Wherever they can they will also use less expensive labor, and there are two ways to do that, each of which has occurred to an accelerating degree in the United States.

One is to in effect import less expensive labor by importing assembled components. Our computer industry imports about 70 percent of the value of the product it sells because they don't want to pay American labor costs if they are going to have to compete in a world market. So if you don't want to pay the payroll tax plus relatively high wages in the United States, you have the components assembled in Taiwan or Korea, bring them in, and stamp your label on it.

The other way to go of course is to simply relocate your production facilities outside of the United States, and again we have seen that this process has continued and accumulated over time.

So we have a number of measures that have been undertaken that are ways to substitute against American labor, and one of the reasons that the substitution occurs is the payroll tax adds 15 percent to the cost of hiring an American worker.

Well, anyway, when I look at all these things together, I am one who thinks that the trust fund surplus presents us with an opportunity to do some rethinking of the objectives of the Social Security program. If it is a safety net program, there are better ways to fund it. There are better ways to design the tax that pays for it, and it can be a lot less expensive.

One of the alternatives that a number of analysts suggest is tax benefits.

That is one way to go, but there again you have bad effects on incentives for individuals who are in the age group who are collecting Social Security benefits. If you put a tax on benefits, then the marginal—the effect on incentives for those individuals can be negative.

I think again it behooves us to look at the trust fund surplus and remember what the trust fund surplus is. It is simply a reflection of the fact that over the past 20 years benefits have risen considerably faster than real wages and then along came a population bulge in the current age group 25 to 45, and the "pay as you go" plan didn't work. So in 1983, we engineered a sharp increase in taxes that will produce a $12 trillion surplus, but under the II-B assumptions of the Social Security trustees we will be out of money again in 2048.

To put it another way, we have managed to save the system for the baby boomers, but if you are a baby boomer and you have a child who was born in 1983, when that child retires, if that child retires at age 65, in 2048, the trust fund will have run out of money again.

Isabel Sawhill said it well. We will either have to raise taxes or cut benefits. I think probably we will have to rethink the system, and if we do, I think we can do a lot better, both in designing the way we pay for it—I think we should pay for it out of general revenues—and also asking what do we want to do with this system? Do we want to have a safety net for individuals who are retired? Do we want to have a significant portion of individuals who pay their country club dues with their Social Security checks? What do we want to do, and what can we afford?

What we have done in the 1980's, as we look at the combination of the effect of the Gramm-Rudman and the budget stringency and the fact that entitlements have not been touched in the process of adjusting outlays, is quite simply compress the resources in the domestic programs, which as a share of GNP have been cut in half, which go toward young, newborn individuals, babies' education, and health care. These programs have been cut in order to meet deficit targets while preserving the increase in outlays on entitlements.

No one seems to have noticed that if you take resources away from investment in the education and the health of younger individuals and transfer them to consumption by retired individuals, that is not going to help your productivity.

I have been fully aware that there are many political difficulties that are connected with rethinking of the Social Security system, but based on the mail that I get when I write articles like this in major newspapers, I think that the minds of some individuals are open on this.

So let me just close by saying that my prepared statement essentially explores these questions in a little bit more depth along with the question of the national saving rate, but let's take the trust fund surplus as an occasion to cause us to rethink the way we want to finance the system and what we want to do with it.

Thank you.

[The prepared statement of Mr. Makin follows:]

PREPARED STATEMENT OF JOHN H. MAKIN

Social Security Trust Fund Surplus

Summary

The social security trust fund surplus manifests more of the weaknesses of the social security system than its strengths. The facts that benefits have grown faster than wages [the payroll tax base] and beneficiaries are rising faster than workers [much faster as baby-boomers retire] means that a "surplus" must be accumulated. The surplus is really a technique for earmarking general revenues for the payment of benefits.

The surplus, if it stays in place is at best a temporary remedy to the problem of matching benefits and revenues. A baby-boomer's child born in 1983 will find nothing left in the "trust fund" to pay his or her benefits upon retirement in 2048 [II-b assumptions]. Such "bankruptcy" occurs earlier in 2030 if the health insurance program's underfinancing is consolidated with OASDI.

Overall, social security, OASDI, begun as a desirable safety net system, has become a regressive, ultimately unworkable system with harmful economic side-effects. It's pay-as-you-go nature leads to benefit growth in excess of wage (tax base) growth when demographic conditions are favorable (1965-1980) and compression of spending on health and education programs for the young when demographic conditions turn unfavorable (1985-present.)

A program that transfers resources from investment in young workers to consumption by the elderly while simultaneously imposing a regressive tax on the employment of labor will help to cut productivity growth and encourage substitution against labor in the production process.

The desirability and feasibility of affecting the national saving rate with the social security system is also questionable. The impact of prospective social security benefits on private saving is somewhat negative and as a compulsory system it forces individuals to make intertemporal decisions they might otherwise not make. Those who claim to the contrary that the social security system is immensely popular or does not effect inordinate intergenerational transfers should be willing to make participation in the system voluntary.

A safety net income maintenance program for our retired population is surely desirable. That could be accomplished simply with a negative income tax that automatically keeps the income of all retirees at least at the poverty line. The cost would be approximately one-fifth the cost of the current social security system and should be funded out of general revenues. The other four-fifths should be returned to the Americans to use for their own saving or consumption as they see fit.

Mr. Chairman, thank you for allowing me to testify before the Joint Economic Committee on the Social Security Trust Fund Surplus. I will confine my remarks to economic issues raised by the Trust Fund Surplus.

The Social Security System will run a large cumulative surplus over approximately the next forty years because a combination of rapid increases in benefits and baby boom demographics requires that a surplus must be accumulated in order to pay currently scheduled benefits. The only alternative would be a sharp payroll tax increase that would have to be levied at some future time on the generation that follows the current baby boom generation aged twenty-five to forty-five.

In one way, the payroll tax increase can be viewed as the outcome of a "pay now versus pay later" question with the answer being to "pay now". However, the "pay now pay later" question carries with it important implications for intergenerational equity. What the post-1983 payroll tax increases say to those currently retiring and expecting to retire over the next forty years is simply this: "if you want the benefits promised under the law governing the Social Security System, you will have to pay higher payroll taxes to get them."

Based on the changes in the Social Security payroll tax enacted in 1980, over the next forty years, payroll taxes and interest earnings paid into the Social Security System will exceed the amount paid out to recipients by a total of about $12 trillion dollars (based on II b assumptions as defined by the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds.)

There has been a great deal of confusion about the economic effects of the "trust fund surplus." What follows are some brief answers to questions frequently asked about Social Security and the "trust fund surplus."

Does the $12 trillion really go into a trust fund that will pay social security benefits from hereon out?

There is no Social Security Trust Fund in the sense that individual contributions are held in trust to pay individual benefits. The promise of generous social security benefits is conditional on the willingness of the working population to tax itself to provide for the elderly population. That willingness is the real "trust fund."

In 1950 there were 16.5 payroll tax-paying workers for every recipient. Benefits were modest. By 1980 the ratio of workers to recipients had dropped to 3.2 and benefits had increased much faster than wages, although by 1983 the per capita income of the over-65 population had come to exceed that of the working age population. The 1983 Social Security "crisis" loomed and payroll taxes were raised sharply. In forty years the ratio of workers to retirees will drop to just 2. Thus, the $12 trillion surplus (about $2.7 trillion in today's dollars) is necessary to avoid a doubling of payroll taxes about twenty-five years from now.

Actually the notion that there will be a $12 trillion surplus is the result more of arbitrary accounting procedures than it is of any trust fund accumulation. In years when the payroll taxes earmarked to pay Social Security benefits exceed the benefits paid the Social Security System acquires special government bonds. The system is credited with the interest on the bonds. The interest on the bonds, which will accumulate to approximately $12 trillion between today and 2030, will be paid by the U.S. Treasury out of general revenues collected from American taxpayers. Thus, the $12 trillion "surplus" just measures another increase in taxes earmarked over the next forty-two years to pay social security benefits.

Should the Trust Fund Surplus Be Counted As Deficit Reduction?

Currently, the surplus is included when calculating the federal government deficit, and therefore the deficit looks smaller. This convention will end in 1993.

Counting the trust fund's surplus when calculating the budget deficit makes two things happen. For the present, the borrowing requirement of the federal government is reduced. In the future, when benefits come due, either taxes will have to be raised again, the government will have to borrow more money or benefits will have to be cut. In short, we will face a Social Security crisis all over again.

If it is desired to maintain the Social Security System as currently configured, an option that I believe deserves further debate and consideration, a prudent path would be to balance the consolidated budget by 1993 and then move toward balancing the federal budget exclusive of any net revenues collected by the Social Security System.

Is The Social Security System Fair?

By most standards it would be judged unfair. The payroll tax is levied at about 15 percent on the first $45,000 of income, half of which is paid by employee and half by employer. For an individual earning $45,000 or less the payroll tax is 15 percent of income. For an individual earning $90,000 the payroll tax is only 7.5 percent of income.

The Social Security System is also unfair across generations. Current beneficiaries receive about $3 for every dollar contributed. By the time the babyboomers retire the ratio will be down to about $1 per $1 contributed. For the children of today's babyboomers, there are currently no dollars available to pay retirement benefits.

The current budget dynamics as driven by Gramm-Rudman-Hollings introduce another unfair negative economic effect on the system. Social Security benefits are indexed to inflation and rise automatically, unaffected by efforts to reduce the deficit. Given this provision, deficit cutting has largely been achieved through cuts in defense spending and cuts in domestic programs including programs for education, prenatal and early childhood care. In effect, in order to maintain and even to increase the real value of Social Security benefits, the federal government has transferred resources away from investment in young future workers toward consumption by former workers. This will inevitably result in slower economic growth and may perhaps be partially responsible for the slowdown in the growth of labor productivity that has appeared in the past decade.

What Other Economic Effects Arise From The Payroll Tax?

The payroll tax is a tax on the employment of labor to produce goods and services. Businesses respond to additional labor costs by economizing on the use of labor in three ways. First, businesses will substitute capital wherever possible for labor. Second, businesses will import assembled components of products like automobiles and computers as a way of importing cheaper foreign labor. Third, more production facilities will be moved offshore to areas like Mexico, Korea, Taiwan and Southeast Asia where labor costs are low.

The rapid increase in payroll taxes over the last decade has corresponded with a moderation in the increase of real incomes of middle income Americans. This outcome may be due partly to the fact that the payroll tax imposes an unduly heavy burden on the employment of labor with incomes up to $45,000. The incentive to substitute against the employment of such labor may have contributed to a slowdown in the growth of income in the middle ranges.

Will The Trust Fund Effect The National Saving Rate?

A fundamental aspect of the impact of the Trust Fund surplus upon the economy follows from its impact on the national saving rate. Aside from the basic question of whether the federal government should try to increase the national saving rate (what is the optimal "saving rate"?) there exists a real controversy among economists about whether it can do so. If individuals see a significant reduction in their take-home pay as a result of higher payroll taxes that they are told will be earmarked to finance retirement benefits, why should they reduce current consumption by the amount of the increase in the payroll tax? Empirical studies have shown that Social Security contributions are viewed by many Americans as a substitute for savings.

In order to assume that the higher payroll tax will come partially out of consumption and thereby produce an increase in the national saving rate, it has to be presumed that either individuals have for some reason decided to increase their net saving, the resources they devote to providing for increases in future consumption, or that alternatively they some how doubt that the benefits promised under Social Security will be forthcoming at current tax rates and they therefore put aside additional saving to provide for expected increases in future taxes.

Viewed more broadly, the impact of Social Security on private saving is related to the degree of rationality attributed to savers. The ultrarationalist school argues that higher Social Security benefits are merely an indication of higher future taxes and therefore cannot reduce private saving. Others argue that taxpayers are not superrational and, therefore, are unable to foresee prospective tax increases that may be twenty or thirty years down the road and so higher Social Security benefits do, to some extent, produce private saving.

Empirically, the private saving rate, that is the share of GNP saved by households and businesses has been remarkably stable for most of the postwar period at about 16 percent. Up until 1980, the saving rate was so stable that the 16 percent level was enshrined as Denison's Law after Edward Denison who observed the remarkably stable private saving rate in the United States.

During the 1980's there has been a drop in the personal saving rate that has been sufficient to depress the saving rate of households and business or the private saving rate. The drop in the personal saving rate has been difficult to explain though some have ascribed it to the way in which private pensions are funded (Makin, 1989) and to the lower saving propensities of the postwar babyboomer generation (Boskin, 1987) or to the negative experience of savers during the 1970's when high inflation rates meant low real rates of return for savers while those who spent on durable commodities or real assets like houses gained rapidly at the expense of traditional savers.

Beyond the question of whether the government can effect the national saving rate lies the question of whether it should and if it does what will be the economic effects. Remembering that net saving represents the provision of resources for increases in future consumption, the saving rate is essentially a question of the allocation of resources between generations. A higher saving rate means that the current generation forgoes consumption in order to provide more generously for future generations. A lower saving rate, as opposed to a negative saving rate, does not mean that future generations are being impoverished as currently is often asserted. A lower saving rate means rather that the increase in the living standard of future generations will occur at a slower rate than it would if the national saving rate were increased. To argue that the federal government should affect the national saving rate is to argue that somehow the federal government has a better idea about the intergenerational-intertemporal allocation of resources than do individuals. Alternatively, it would be necessary to argue that more future goods, that is more provision for future goods through higher saving, somehow provides positive externalities to the economy that the government ought to encourage.

One of the often mentioned benefits of a higher saving rate is a higher growth rate for the economy and higher income per capita. Here again some careful consideration is necessary. If the rate of saving increases and thereby lowers market interest rates and encourages capital formation, neoclassical growth theory suggests that real wages and output per capita will rise. What is often forgotten is that neoclassical growth theory also suggests that there is a "golden rule of growth" which states that a saving ratio persistently in excess of the optimal saving rate will increase gross national product per capita but it will make consumption per capita lower. The reason for this seemingly paradoxical result is that depreciation on a larger than optimal capital stock and diminishing returns from a higher capital labor ratio will leave less resources available for consumption per capita. I suppose an intuitive illustration of the golden rule might come from a small business that prospers over time and acquires so much machinery that in the face of the given growth of the available labor supply is unable to hire enough individuals to maintain its large stock of machinery.

Those arguing for higher saving and therefore higher capital formation are presuming that the saving rate is below the level consistent with the golden rule of accumulation that maximizes consumption per capita.

There are other possible "slips twixt cup and lip" when considering the benefits associated with a high national saving rate. In an open economy, higher national saving may spill out into world capital markets thereby effectively failing to depress the interest rate and thereby further failing to encourage capital formation. Further, if for a large economy like the United States, an increase in the national saving rate is sufficient to depress interest rates and thereby to enhance capital formation, there is no guarantee that American consumers will capture the benefits. If American exports are produced with capital intensive methods an increase in the stock of American capital will lower the price of our exports relative to the price of our imports. This so-called deterioration in American terms of trade means that a unit of American exports will buy less imports. The effect of a deterioration in our terms of trade is to have American capital accumulation benefit American trading partners by making American exports less valuable in terms of American imports.

The overall point is that much of the traditional analysis about the benefits of faster capital formation has been done in a closed economy setting. This setting is inappropriate for the 1980's as the American economy becomes more open and more reliance is placed upon our ability to export to world markets.

Beyond the qualifications already raised it is important to remember that if an increase in the saving rate does lower the interest rate, the result is to increase the desired capital stock, therefore, the growth of the capital stock through a higher level of investment and the resulting increase in output and consumption per capita will occur only temporarily provided that the saving rate is below the level consistent with the golden rule of accumulation.

What Are The Options For Policy Changes On Social Security Implied By The Trust Fund Surplus?

The Trust Fund surplus is, viewed in one way, a dramatic illustration of the difficulty of maintaining an essentially pay-as-you-go federal retirement system where two conditions exist. First, benefits have grown faster than wages, and second, demographics imply that an unusually large generation will be followed by an unusually small generation.

The much heralded Trust Fund surplus and rescue of the Social Security System by the 1983 Social Security legislation can be misleading. Under current assumptions II-b, a child born in 1983 will find no resources in the "trust fund" when it reaches retirement age in 2048.

There are alternative less expensive and less regressive ways to provide a safety net for elderly Americans. The original intent of Social Security could be provided by a negative income tax. Under that approach any American over age 65 with an income that was below the poverty line would receive a check from the federal government raising his or her income to the poverty level, slightly above or slightly below, depending on considerations of equity and incentives. Although the program would be financed out of general revenues, such a negative income tax approach would cost less than one-fifth of the cost of the current Social Security System. It would also eliminate the regressive payroll tax that discourages employment of American workers and may be accelerating the movement of American jobs abroad or accelerating its replacement by machinery or foreign labor in the form of assembled foreign components.

The attention-grabbing $12 trillion Social Security "Trust Fund Surplus" has been beneficial in that it has encouraged some fresh thinking about attractive alternatives to achieve income security for elderly Americans. While the consequences of today's decisions lie far ahead, one fact is certainly true: we can make Americans under age forty-five better off while not harming either current retirees or this within ten years of retirement by gradually returning the Social Security System to a safety net system and allowing Americans to do more of their own retirement planning by returning to them a large portion of taxes now collected as payroll taxes.

Representative **Hamilton**. Well, thank you very much. We have a mild difference of opinion out there on Social Security, and that will make for a good discussion this morning.

We appreciate your testimony.

Let me just pick up where you ended off, Mr. Makin, to begin with the proposal you make about the negative income tax, which would keep the income of all retirees at the poverty line, and your phrase was an interesting one to me when you said that if Social Security is a safety net income maintenance program then the better way to do it, as I recall your testimony, was by the negative income tax.

I wasn't around in the 1930's when the Social Security—at least I wasn't aware of these things when the Social Security program was put into effect, and that may very well have been the initial purpose, but my perception of it is that the American people no longer really look at it that way.

I think most of my constituents look at the Social Security program not as a means of providing a certain safety net to keep them out of poverty. They look upon the Social Security system as a system that will provide them with an adequate—whatever that word means—level of income.

Now, that may not be the right way to look at it. It may not even be the way it is intended to be looked at, but that is the way they do look at it, I think.

Mr. **Makin**. Yes, I think it depends very critically on the age group of the individual you speak to, and I think people overlook that moving toward a different system of course would entail a great deal of careful explanation. Much depends on how you put it to the people. I use my airplane test. Everybody I sit next to on an airplane I try out some of these ideas, and I find actually that there are a number of people who, if they understand that the idea would mean that their take-home pay would increase by about 10 percent if you are going to essentially take out the 12 percent of the 15 percent for OASDI and that in return they would know that when they retire they are never going to be in abject poverty but they are also going to have 10 percent more take-home pay with which to provide for a higher level or higher standard of living when they expect to retire, are supportive.

In other words, what you are doing is saying we will leave that decision up to you. I think if you speak to individuals—again, if we are looking here only at opinion—if you speak to individuals under the age of 35, most of them say, well, I don't think I am going to get anything under the current system anyway, and so the only consolation I have is that my parents are being well taken care of.

And, finally, I would say if you made participation in the system voluntary, I suggest that many people would vote effectively against the system by pulling out of it.

Representative **Hamilton**. What do you think of that, Mr. Ball?

Mr. **Ball**. Mr. Chairman, I hadn't realized we were going to have a basic seminar on the purposes of Social Security as distinct from the surpluses, but I am very happy——

Representative **Hamilton**. I will get to the surpluses in due time.

Mr. **Ball**. I am very happy——

Representative **Hamilton**. I am the one that got us off track a little bit here.

Mr. **Ball**. No, no. No, not at all. It is Mr. Makin who is raising the fundamental questions, and I think it is very interesting, and I am glad to comment on them.

First of all, the history is wrong. The idea was not to have just a poverty program. When the Social Security Act was passed in 1935, there were two parts. There was a public assistance part, which consisted of grants to the States—the States put up half the money and the Federal Government put up half the money. It is like our SSI program, which is all Federal now. That was a poverty safety net program.

But the Social Security concept was that by deductions from workers' earnings—and I think we have gotten off on the wrong foot sometimes because economists use shorthand and tend to call it a payroll tax. The concept was supported by deductions from workers' earnings so that they were paying towards protection for themselves, with matching amounts from their employer, with the idea that the system would build over time so that those contributors, like the workers in every industrial country in the world—this isn't a U.S. phenomenon—would have social insurance protection which would serve as a base to which people would then add private pensions and personal savings. About half the workers in the country are covered for a supplement to Social Security now from either a private pension or a government career pension, State, local, Federal civilian and military. The idea was that most would have protection that went beyond protection against poverty. Social Security was to be a base for everyone and you carried that protection with you from job to job. You were not inhibited from making savings by the idea that they would then be deducted from your basic Social Security benefits. When you have an income test or a means test, you undercut incentives for people to save on their own or to have private pensions since such income reduces the Government payment. You have to have the prospects of an income well above the minimum government benefit in order to feel that it makes sense to save or to have a private pension.

So the concept was from the beginning—and it has stayed much the same—that benefits grow out of earnings that people have had in the past so that they feel an earned right to the benefits. It is not just the contributions that distinguish Social Security from welfare. The relationship between contributions and benefits is not direct. It is there, but it is somewhat indirect, but equally important is the fact that you get the benefits only because you have a wage record and the amount that you get depends upon those earnings. This makes everyone—with a few exceptions like Mr. Makin, but I think almost everyone—feel that their benefits are earned and grow out of the work that they have done in the past.

It is a very different program than the negative income tax, wherein how much you do for people depends on the minimum poverty level that you establish at a particular time. Such a welfare approach has very little stability to it. It depends on the nature of the times. It depends on the generosity of the people making the law in a given year. There is no guarantee that this will be the level 20, 30, or 40 years from now.

There is no absolute guarantee even in the Social Security approach, but the fact that the benefits grow out of past work and are reinforced by contributions makes it a much more secure system. It makes people unlikely to vote for representatives who say let's forget about those past promises.

Representative HAMILTON. There isn't any doubt, though, Mr. Ball, that Mr. Makin has a point, and I run into this myself repeatedly, and that is that younger people do not have the confidence in this system that those of us who are older have——

Mr. BALL. Can I——

Representative HAMILTON. Yes, I would like you to comment on it.

And that the idea that they would have 10 or 15 percent extra income out of each paycheck is very, very appealing to them, and I think there is a large percentage. I don't know that I have seen any polls, but I think there is a very large percentage of young people today who really don't think that when they retire the check is going to be there.

Mr. BALL. I would like to reply to that, Mr. Chairman.

Representative HAMILTON. And it is a significant group. I don't know whether it is a majority or not. It is a significant group.

Mr. BALL. It is even worse than you are suggesting, in a way, and that is that the lack of confidence isn't confined to younger people. The overall level of confidence in the future of Social Security reached an all-time low in 1981 and 1982, when the papers and radio and TV were full of the idea that the system was going bankrupt, and people quite understandably said if there is not going to be any money to pay benefits 6 months from now, how is there going to be anything there for me later on.

Most people seem to think of financing of the program as dependent on the trust funds rather than on future taxes, which is wrong of course. The main source of income to the system is future taxes.

But confidence has begun to rise. It reached a low across the board—not just young people—of like 30 or 35 percent. There have been public opinion polls on this right along.

Representative HAMILTON. 30 or 35 percent believed what?

Mr. BALL. Had confidence that they would receive benefits.

Representative HAMILTON. Had confidence.

Mr. BALL. That has risen—not to a point to throw your hat in the air about—but has risen to about 50 percent in recent polls. The confidence level has been tracked by several polls, and it has risen as the trust funds have been built up and the system has been reported as being in a sound financial state.

But an interesting point, Mr. Chairman, is that there has not been significant differences by age group. The young people have a slight, just a slight——

Representative HAMILTON. How about income level?

Mr. BALL. Not significant. This has been a phenomenon of lack of confidence across the board and confidence has begun to rise across the board. And there has been an interesting, almost contradiction, in that the same groups that say, "Oh, I am not going to get my own benefits," when asked other questions indicate that their support for the system is very strong. They say they like the system.

They are willing to pay more for it if it is necessary but still say, "I don't think I will get my own benefits."

That is changing. It has begun to change, and there are several polls that I would be glad to put together and submit for the record if you would like.

Representative **Hamilton**. Well, I think we would like to have them, sir, if you have them. As you say, it is not quite on the point of our hearing.

[The following information was subsequently supplied for the record:]

Polls on Public Confidence in Social Security

Over the past decade or so, polls have shown that public confidence in the long-run ability of the Social Security system to pay benefits declined in the late seventies and early eighties, and has recovered to some extent in recent years. In some polls confidence varies among different age groups, but income seems to make little difference. In addition, despite low levels of confidence, the public is still very supportive of the Social Security system.

Gary Eldred reported in the Journal of Risk and Insurance (June 1977) that the American public did not believe that the Social Security system was financially sound. Thirty-eight percent of the respondents agreed to the statement "The Social Security system will soon go broke." In addition, only 12 percent agreed to the statement "the Social Security system is financially sound," while 72 percent disagreed.

In a 1979 survey conducted by Peter D. Hart, for the National Commission on Social Security, 62 percent of nonretired Americans expressed little or no confidence that funds will be available to pay their retirement benefits. These doubts were expressed by almost three quarters of those between the ages of 25 and 44. Those currently receiving benefits showed much more confidence in the system, with only 19 percent stating little or no confidence in the system. Despite the lack of confidence, those polled still supported the program. Hart found 69 percent would even favor paying higher payroll taxes to avoid lowering benefits.

The National Council on the Aging conducted a survey with Lou Harris and Associates monitoring public opinion toward Social Security in 1981. They found that 65 percent of those polled had "hardly any confidence that the present Social Security system will be able to pay them benefits when they retire." Fifty percent agreed that Social Security taxes should be raised if necessary to provide adequate benefits and 85 percent disapproved of reducing benefits for those retiring in the future.

A June 1981 poll done by CBS and the New York Times found that 54 percent of the American public "doubt that Social Security will provide full benefits for their own retirement." Age breakdowns showed less confidence among younger respondents: 75 percent of those 25-34 expressed doubt, 64 percent of those 35-44, 56 percent of those 45-54, 34 percent of those 55-64, and 13 percent of those 65 and over. Income level did not appear to effect one's confidence in the system: 57 percent of those earning $10-20,000 expressed doubt, 59 percent earning $20-30,000 and 62 percent earning $30,000 and above. Again, despite lack of confidence, 66 percent said they would favor a tax increase if "necessary to keep the Social Security system going."

A 1982 Gallup survey for the U.S. Chamber of Congress indicated that 63 percent of employed Americans were afraid they might not receive any Social Security benefits when they reached retirement age, while another 16 percent believed benefits might not be as good as they are now. A January 1883 poll done by CBS and the New York Times found only 27 percent of the public believed that the Social Security System will have the money available for the benefits they expect upon retirement.

Yankolovich, Skelly and White did an extensive survey of public opinion in 1985 for the American Association of Retired Persons. In this "Fifty-Year Report Card on the Social Security System" 52 percent of those surveyed had little or no confidence in the Social Security system. The younger respondents were less likely to express confidence in the system than older respondents: 67 percent of those 25-34 expressed little or no confidence, 64 percent of those 34-44, 49 percent of those 45-61, and 31 percent of those 62 and older. An examination of nonretired Americans showed that 66 percent thought it very likely or somewhat likely that payments would no longer be given when they retire. Again, the younger respondents showed less confidence in the system than older respondents. The Yankolovich survey also showed that 92 percent of the American public thought that Social Security had been very or somewhat successful, and 65 percent thought it was "one of the very most important programs of government."

The American Council of Life Insurance annually reports the results of its Monitoring the Attitudes of the Public (MAP) survey. The 1988 MAP survey showed that for the first time in several years, concern about the solvency of Social Security had declined. Public confidence in the Social Security system rose significantly between 1986 and 1988. Overall, 49 percent say they are very confident or somewhat confident in the future of the system, up from 39 percent in 1986 and a low of 32 percent in 1982.

Representative HAMILTON. Before going to the Senator, I wanted to check with the other two witnesses to see if they have any further comment on this particular topic.

Ms. SAWHILL. If I could come in on this topic, it seems to me that your initial comment about the public's view of this is right. They do view it as a social insurance system and a contributory system, as Mr. Ball has said, but one can still raise questions about what that base of support should be, how high benefits should be. I think John Makin is right when he emphasizes that the elderly are much better off now than they used to be, and in the next century they will probably be better off still because they will have more adequate pension coverage and a higher level of savings. They may be able to work longer. In short, they will have other sources of income available to them.

John Makin's provocative comment about some people using their Social Security checks to pay their country club dues seems to me apt, and putting all of that together, I think we can talk about maintaining a social insurance system that provides a basic benefit for retired people, but which income relates those benefits more than we do now, so that one doesn't go all the way to a means-tested program but one does begin to, for example, tax Social Security benefits to get at some of the inequities that I think John Makin was alluding to.

Representative HAMILTON. Mr. Makin.

Mr. MAKIN. I first want to bow to Mr. Ball's superior knowledge of the history of the system, but I think perhaps more relevant is the question that we face today in 1989. Remember that a "pay as you go" system is going to almost by definition be very popular in its early stages.

Mrs. Ida Mae Fuller was the first beneficiary under the system. She lived in the town where I was born in Brattleboro, Vermont, and people in Vermont tend to live a long time, and I think she collected something like 900 times what she paid into the system, but you would expect that early on.

Current beneficiaries also do quite well relative to contributions to the system. When we look ahead, however, the ratio becomes less favorable, quite simply because the number of people who are going to be beneficiaries increases; that is, when the current 25 to 45 population bulge retires and is followed by a smaller generation.

I really think that now is perhaps the time to think of the post-trust-fund buildup questions. Are we going to say, well, we are going to have another big tax increase? Because when I say moving to a different system, whatever it may be, obviously you are talking about a 25-year, a full generation transition period. I don't mean that you say today to someone who is 64, sorry, we are going to a negative income tax, you are out of luck. You have to make a transition over generations in order to do it and in order to address the question of what are you going to do with baby-boomer children. Are you going to raise taxes again?

You have to start thinking seriously now about whether you want to make some longrun adjustments so that people can adjust their plans for retirement.

Representative HAMILTON. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

My own perspective is from a State background. In my State our public employees retirement system includes State employees, school district personnel, and municipal government and other local government and special district employees. These participants are all part of a public employee retirement system that is an alternative to Social Security. I believe Nevada may be only one of like nine States whose public employees do not participate in Social Security. We, with the contribution rate that we have, have built up an enormous surplus for a small State. It is several billion dollars.

And in talking with my constituents, they are rather astonished to learn that that money that is referred to as a Social Security trust fund really isn't there and that it is used to finance the deficit. They are appalled, shocked. I must say myself before coming to the Congress I didn't fully understand and comprehend it.

What is wrong with the Federal Government adopting a system akin to what we have at the State level, use that surplus to invest in a wide range of prudent investments, to allow those surpluses to continue to build because the recipient base will continue to grow and to expand?

I know that having read your prepared statements you take different views, but, Mr. Makin, let me ask you first if I may and then have Ms. Sawhill and Mr. Ball if the chairman has no objection.

Representative HAMILTON. Sure.

Mr. MAKIN. Well, Senator, I think actually the idea of a fully funded system as opposed to a "pay as you go" system is perhaps more appealing and would be more in keeping with the expectation that most of your constituents have when they hear about the trust fund, and so I would not in principle be at all opposed to the approach. I think it is superior to "pay as you go." I would still rather go the other way and fund the system out of general revenues.

The real question would be what level of benefits do you want to provide from an accumulation of assets, and there again you face the same question in a way, how you accelerate the flow of funds into the system and would you essentially be dealing with this where each individual pays in and has an accumulation that is under their name and their number?

Senator BRYAN. I wouldn't suggest that, Mr. Makin. I am talking about something that would be a pool of funding, that the benefits would be uniform, recognizing that some participants would receive far more than their contributions, but that there would be a defined base, and to respond to your question in terms of what the benefit level, I suppose wouldn't at least one of the policy judgments that the Congress would have to make if you went to a fully funded system is what the surplus generated would support on an actuarially funded basis and how much more the contribution rate would have to be increased either by the payroll tax or for the general revenue fund contribution that you favor to increase the benefit program.

Mr. MAKIN. Yes, you would have to make those choices, and of course in our current situation of—I will describe it as fiscal stringency—it might be difficult to accelerate compulsory contributions, called taxes, but I would say—let me just say in general, I think that is one of the options that we could seriously look at.

I do have some reservations about the notion of a massive collection of resources administered by trustees, one set of trustees, simply because I am not sure that I wouldn't rather have more views on how to invest the money.

I would, in effect, rather say to an individual—and this is a very basic question—I would rather say to an individual, as a society we are not prepared to see you in your old age in poverty, but as a society we are prepared to allow you to make these choices about how you are going to spend your resources over your lifetime with this protection in place. That is why I essentially go to the plan I suggested.

And I do think that as I ask people there is a little bit of the Christmas Club mentality that applies to Social Security; that is, people join Christmas Clubs because they don't trust themselves to save for Christmas presents. Perhaps people support Social Security or other such measures because they don't trust themselves to provide for their old age.

Again, there isn't too much evidence that that is really the case, but that is why I would really rather allow people to make more of those intertemporal choices.

Finally, of course, there is always an element of compulsion in participation in a system like Social Security, or I assume that contributions to the funded system would also be compulsory.

Senator BRYAN. Yes, you would have to.

Ms. Sawhill.

Ms. SAWHILL. I think it has some merit, your proposal, but let me point out some of the possible problems with it.

One is that it puts a great burden on the generation that is asked to make the transition from a "pay as you go" or partially funded system to a more fully funded system because that generation is both helping to pay for the—or is paying for the retired generation's benefits and at the same time funding their own benefits. It would in the current context put a particularly heavy tax burden on the baby-boom generation.

Many would argue that that generation is already having a tough time. Their earnings haven't increased very rapidly partly because there are so many of them and they are competing with each other, partly because they have lived through a particular slice of history which has not seen very good performance of the economy. They have had to adapt by doing things like having fewer children and sending second earners into the labor force, or so the conventional wisdom about this goes, and I think some of it is true.

To then ask them on top of that to fully fund their own retirement would be, I think, an extremely burdensome proposal.

Another comment I would make is that it might be worth looking at the experience of other countries as well as States, as you mentioned, that have moved in this direction. There are three countries, as I understand it, that try to do this—Sweden, Canada, and Japan.

There is always the issue of once you move to a fully funded system how are the assets that are built up used, and there is always a temptation in the political world to use them to achieve various social objectives, and there are bound to be debates about how to allocate this new source of capital.

There aren't necessarily reasons not to go in the direction of fuller funding. These are just things to think about and reasons to look at the experience of these other countries.

Senator BRYAN. How do the three countries that you have mentioned handle their investment policy?

Ms. SAWHILL. I am not familiar with the details. I believe in Sweden they have four different funds, which are handled in different ways. In Canada, I believe they use a lot of the money to finance spending at the local level. It becomes a source of money, in other words, for municipal governments and that in turn frees up more savings or credit for use in the private sector that would normally be financing local government.

So I think the pattern varies, and I am not familiar enough with it to give you the details without going back and doing a little more homework.

Senator BRYAN. Mr. Ball.

Mr. BALL. Senator Bryan, I think I could say that we are moving in your direction under present law, really very strongly, and probably as far as it is feasible to go.

Young people who are starting out to work now, with their employers, are just about paying their own way, and the reserves will be built as a result. If we can maintain them as reserves and balance the non-Social Security budget, they will be invested in existing government debt, which will free up private investment.

And I also, as I suggested earlier, would argue that we could use the reserves, to an extent, to increase government investment.

But to go beyond putting the cost of their own benefits on the young and require middle-aged workers to pay fully for their own protection, I don't think would be quite practical. They are too far along, as Ms. Sawhill suggested. But a partially funded system, though difficult, and I don't think essential for Social Security, does have the important byproducts that both Ms. Sawhill and I have suggested. I think it would be a desirable thing to do.

Could I while I have the floor, Mr. Chairman, make a couple of comments on other things that have come up?

Senator BRYAN. Before doing that, could I have a followup question, Mr. Chairman?

Representative HAMILTON. Sure. We will take time for both.

Go ahead.

Senator BRYAN. Mr. Ball, I think the difficulty that some of us that are new to the Congress have with the way in which the present system is presented to the public, it strikes me as being intellectually dishonest and deceptive to talk about that Social Security surplus and then when we are talking about our national deficit we thump our chest and proclaim proudly that we have entered into a bipartisan accord with the administration, Democracts and Republicans, both in the House and the Senate, and we tell the American people, you know, we are going to be able to meet that Gramm-Rudman-Hollings threshold and we are really getting a handle on the deficit, but in point of fact, as we all know, those Social Security funds are incorporated in what I would say is an extraordinarily unusual way, at least in terms of public understanding and perception, to in effect reduce our deficit and give us the impression or the allusion that we are making some progress.

And when you talk to people about it—I am not talking about highly sophisticated people who understand all of the arcane, Byzantine rules that we have in terms of accounting—I think they are shocked. There is something that strikes me as being fundamentally wrong in representing our surplus in that fashion.

Could you comment, giving your own reaction to that?

Mr. BALL. Well, I agree with you. I think that over the long term Social Security should be completely outside our discussion of deficit targets and should represent roughly a surplus in the unified budget. If it is accounted for separately, it would be much clearer and more understandable for people to follow.

My reluctance goes only to doing it right away and all of a sudden. I think it is just to hard to bring down the deficit so fast, and it would put such pressure on other government programs that are very important if we tried to balance the non-Social Security budget all at once. I was suggesting that after the Gramm-Rudman targets are met with Social Security included that we then start another process that would balance, more or less, the non-Social Security budget unless you choose the alternative route, which I really like, of partly doing that and partly using Social Security reserves for direct government investment.

Senator BRYAN. Thank you very much, Mr. Chairman.

Mr. Ball had another comment, I think.

Mr. BALL. Yes, I really wanted to comment on two or three things, Mr. Chairman, rather quickly if I may.

One is we have been talking as if Social Security were entirely a program for the elderly, and I think that is a mistaken impression to leave. It is a very important program for the totally disabled, for their dependents and the dependents of the elderly. It is also an important survivorship program.

I think very few people realize that the face value of the life insurance under Social Security is somewhat higher than all the private life insurance in the country, including group and individual—all the private insurance that exists. The protection for widows and widowers and children is greater under Social Security than private life insurance. There are nearly 3 million children who get a Social Security benefit every month.

So we shouldn't think of Social Security entirely as transferring money to elderly people.

Another point that I wanted to make is that, yes, the position of the elderly has very greatly improved in the last 10 years, but it has improved almost entirely because of Social Security.

The Census recently issued a report that would be of great interest to the members of the committee if they haven't seen it, in which they conclude that without Social Security something like 50 percent of the elderly drop below the poverty level. I will submit their conclusions for the record.

[The following information was subsequently supplied for the record:]

Measuring the Effect of Benefits and Taxes on Income and Poverty: 1986

CURRENT POPULATION REPORT

Consumer Income
Series P-60, No. 164-RD-1
Issued December 1988

POVERTY STATUS

A review of the data shows that the income component that had the largest effect on the poverty estimate was Social Security (the primary component of nonmeans-tested government cash transfers). Other types of government transfers had smaller incremental effects.

The incremental effect of income components on the poverty status of persons by age group is shown in table H. The data show clearly that the effect of government transfers on the poverty status of persons 65 years and over is very large compared to the effect of such transfers on the poverty status of young persons. The percent of older persons (65 years and over) in poverty was 47.5 percent before government transfers were added to the income definition (definition P5). The addition of nonmeans-tested cash transfers (primarily Social Security) reduced the rate to 14.0 percent (definition P6) and the addition of other government transfers brought the rate to 9.0 percent (definition P10). The total effect of adding government transfers was to reduce the poverty rate of older persons by 81.1 percent. Among those under 18 years of age, the before-transfer poverty rate was 24.0 percent (definition P5) and the addition of all government transfers brought the rate to 17.1 percent (definition P10). The effect of government transfers was to reduce the poverty rate of young persons by 28.8 percent.

Counting the net imputed return on equity in own home has a larger effect on poverty rates for older persons than for other age groups. Table H shows that counting this component would reduce the poverty rate of persons 65 years and over by 36.7 percent (from 9.0 to 5.7 percent), compared with 21.0 percent (from 8.1 to 6.4 percent) for persons 45 to 64 years, and 6.7 percent (from 9.0 to 8.4 percent) for persons 25 to 44 years.

Table H. Percentage of Persons in Poverty, by Age and Definition of Income: 1986

Definition of income	Under 18 years		18 to 24 years	25 to 44 years	45 to 64 years	65 years and over
	Total	Related children				
All persons (thousands)	62,948	62,691	26,463	76,267	44,901	27,975
Income before taxes:						
P1. Money income excluding capital gains (current measure)	20.6	20.2	15.6	10.2	9.1	12.4
P2. Definition P1 less government money transfers	23.4	23.2	18.6	12.7	15.2	48.5
P3. Definition P2 plus capital gains	23.0	22.8	18.2	12.4	14.8	47.1
P4. Definition P3 plus health insurance supplements to wage or salary income	22.2	22.0	17.7	11.9	14.5	47.0
Income after taxes:						
P5. Definition P4 less income and payroll taxes	24.0	23.8	19.5	13.2	15.4	47.5
P6. Definition P5 plus nonmeans-tested government cash transfers	21.9	21.7	17.3	11.3	10.2	14.0
P7. Definition P6 plus the fungible value of Medicare	21.7	21.5	17.1	11.1	9.7	11.6
P8. Definition P7 plus means-tested government cash transfers	20.8	20.5	16.2	10.5	9.0	10.1
P9. Definition P8 plus value of food and housing benefits	18.2	17.9	14.9	9.4	8.3	9.1
P10. Definition P9 plus the fungible value of Medicaid	17.1	16.9	14.3	9.0	8.1	9.0
P11. Definition P10 plus net imputed return on equity in own home	16.0	15.7	13.7	8.4	6.4	5.7

Mr. **Ball**. So it is a little circular to say now we have the elderly in a good position we can afford to do away with Social Security or redcuce it, since Social Security is the main reason for their improved economic position.

On the other hand, I agree with Ms. Sawhill that over time the taxation of Social Security benefits to a greater extent than at present would be highly desirable. I have to say that I guess more than any other single person I am responsible for the fact that benefits are presently taxed at all. I have favored taxing benefits for the last 20 years or more. I was the one who argued for it in the 1978–79 advisory council which recommended it, and in the negotiations in 1983 on the National Commission on Social Security Reform, the Greenspan Commission, of which I was a member, I was the one that pushed the taxation of Social Security benefits.

The most that we could agree on was to tax 50 percent of the benefits of upper income individuals, but the policy should be to treat Social Security retirement income the same as private pension retirement income. That policy basically is to tax that part of the benefit that exceeds what you yourself have paid. If applied to Social Security this policy would tax about 85 percent of the benefits. I have no brief whatsoever for special treatment of well-off elderly people. That is not my purpose whatsoever.

The purpose of Social Security is to have a base on which everybody can depend, that follows the workers from job to job. Hopefully, workers build more protection on top of it. Then you have fair tax treatment of everybody, not special treatment just because people are old.

Senator **Bryan**. Thank you very much, Mr. Chairman.

Representative **Hamilton**. OK. Let's spell out for me the way this works when you talk about—I guess several of you talked about the procedure that we now have of using the Social Security reserves to pay for the current expenses of government. Spell that out for me. How is that done?

Mr. **Makin**. Well, typically Social Security is on the consolidated budget. Until recently, we haven't taken in more money than goes out. So let's say that this year approximately $50 billion more comes in than goes out in the Social Security system. That $50 billion under the 1983 compromise was to have been accumulated in order to fund an acceleration of payout as the baby boom retires.

Now, if we then use that money instead to finance outlays by the Government on other issues, essentially what we are saying is that we are going to have to accumulate another $50 billion in order to do the funding and we haven't accumulated it. We have essentially spent it.

Representative **Hamilton**. You take that surplus, you invest it in securities, right?

Mr. **Makin**. You invest it in securities. Remember, one of the things that is happening with the trust fund—I will use the words "trust fund," though it is not—is that you are essentially earmarking revenues to pay Social Security benefits. That is really what is happening. When you take in $50 billion more, you essentially buy a special issue of Treasury securities. The interest on those securities is paid out of general revenue and is earmarked to pay future benefits. Therefore, you are paying benefits with more than payroll taxes.

Now, if you then—let's suppose that you end up after 20 years having earmarked all those revenues to pay benefits but actually used the proceeds of the borrowing to finance other programs, then if you are going to pay benefits and pay the interest, you are going to have to raise taxes again.

Representative HAMILTON. So, look, for my constituents what I tell them is that their payroll taxes are going into a pot and eventually that money works its way into paying for welfare and foreign aid and health care and everything else, right?

Ms. SAWHILL. In 1993, the non-Social Security expenditures of the Government are going to be something like $220 billion. The Social Security surplus is something like $100 billion. So we use that excess of payroll taxes over benefits that are being paid to finance about $100 billion of——

Representative HAMILTON. Of general government expenses?

Ms. SAWHILL [continuing]. Other Federal expenditures.

Representative HAMILTON. Right. So their money——

Ms. SAWHILL. So on a consolidated basis——

Representative HAMILTON. In effect, their payroll tax is going to support all of the activities of government?

Ms. SAWHILL. A big chunk of them are. But let me make an argument about that.

Representative HAMILTON. Do you think most people understand that?

Ms. SAWHILL. Probably not very much.

Representative HAMILTON. Do you think most people would approve it if they did understand it?

Ms. SAWHILL. No, but I think that there is another level of understanding at which they might. I think that there is real merit in not segregating particular revenue sources or particular outlays in the Federal budget and saying we have to, you know, earmark taxes that match up with a certain level of outlays on the other side of the budget.

Imagine what happens if you start doing that with a whole lot of different program areas.

Representative HAMILTON. When the Social Security system was first put into effect, was it thought, conceived that these payroll taxes would go into financing the operating expenses of government?

Mr. BALL. That is not too easy a question to answer, Mr. Chairman, because it was always provided by law that any surplus that exists, any annual surplus—they are not really surpluses, but reserves—any annual surplus that exists is to be invested in government bonds. Bonds, of course, are nothing but an IOU, and the Government then takes the money and uses it for whatever purpose the Government wants to use it for.

Representative HAMILTON. So it is correct to say to the constituents that we haven't changed anything; we are doing exactly what we did in 1935 and 1936?

Mr. BALL. Except—and here is the point I think all three of us have been emphasizing—and that is when you run a large deficit in the unified budget, then instead of a buildup in the Social Security funds leading to greater private investment and a larger pool of goods and services later, it is going entirely to pay for a combination of operating expenses of the Government and investment by the Government. None of this mattered very much in the past because Social Security was not building large reserves.

But the basic procedure is the same.

Representative HAMILTON. The same.

Mr. BALL. The basic procedure is to invest in government bonds, which are IOU's, and the money is then available to the Treasury to use for the basic purposes of government.

Ms. SAWHILL. If I could add to that, the money is going to be spent on something. So if the public thinks somehow or other that their payroll, their excess payroll taxes that aren't needed to pay for current benefits, aren't going to get spent, either on current non-Social Security outlays of the Government or else if we use the surplus to retire some debt the money is going to get spent in the private sector, one way or the other their payroll taxes are gone.

So that if what they are looking for——

Representative HAMILTON. I don't think they understand that, though.

Mr. MAKIN. Mr. Chairman, I think that when we talk about the surveys on the confidence in the system, I don't think that most taxpayers would be able to explain to you exactly what is going on, but I think that they have a sense from glancing at op-ed pages and newspapers or television that something is going on that is perhaps not consistent with the notion of a trust fund certainly——

Representative HAMILTON. Right.

Mr. MAKIN [continuing]. And that they are therefore uncomfortable, and in some cases, again, it is very age related. If they are close to retirement, they are uncomfortable because they are afraid, understandably, that the benefits that have been promised will not be forthcoming. It is remarkable how people don't distinguish between adjustments in the increase in outlays; that is, COLA adjustments, and total disappearance.

Again, there I use my "Aunt in Spokane" test, and Aunt Pat, whenever there is a big thing on TV about Social Security, she says, are they going to take my Social Security away, and I say, no, they are not going to take it away. They are talking about—and it probably won't happen—having it go up 3 percent instead of 4 percent next year.

Any then with the person age 20 and 30, they say, well, they are spending the money, anyway, so it is not going to be there for me, so why should I support this system.

Mr. BALL. Mr. Chairman, could we follow through on Ms. Sawhill's point just a little bit further?

It is certainly clear that the money has to be spent currently and then it has to be made available later. But you are in a very different position to make it available later if the money has in one way or the other been invested, so that the burden of raising the money later is less. On another level, a different kind of issue, if you have transferred the general government debt to Social Security because the trust fund purchases a large part or all of it, the servicing of a debt held by the public doesn't have to occur at the same time you also raise money for Social Security. The amount you raise for

Social Security is the same, but part is labeled as interest on bonds held by Social Security and you don't at the same time have to pay interest on bonds held by the public.

Representative HAMILTON. Well, let's talk a little bit about these investments you want to use the surpluses for. Ms. Sawhill, you want to take half and put them into a trust fund after 1993—that is assuming we hit the targets of Gramm-Rudman—for qualified public investment and half for private investment, right? What is a qualified public investment? Who is going to decide it?

Ms. SAWHILL. Well, that is the really sticky part of this proposal, obviously. It would have to be a political decision, but one would hope that those decisions would be made in a way that didn't allow every expenditure that——

Representative HAMILTON. One would, of course, hope that the money would go to a qualified public investment; you apparently think it would be or you wouldn't make the recommendation; is that right?

Ms. SAWHILL. I have thrown it out as an idea worth debating and discussing.

Representative HAMILTON. You have a lot of confidence in us then, haven't you? [Laughter.]

Ms. SAWHILL. Actually, the more I have thought about it, the more I think it would be unwise——

Representative HAMILTON. Or you don't have confidence. [Laughter.]

Ms. SAWHILL. I didn't answer that.

Representative HAMILTON. Yes.

Ms. SAWHILL. No, I have confidence.

I think it would be unwise to earmark this in a legal sense, you know, setting up a separate trust fund to do this. I think it is probably better if we think about it as an investment in the future and try in some more general sense to make those investments for all of the reasons that Bob Ball has suggested. Public and private investment are complimentary and we need more of both, and I have laid out a formal proposal that captures that idea.

Representative HAMILTON. Well, who would make the judgment about the qualified public investment and who would decide what private investment you are going to make?

I mean, you have race tracks over here and you have horse races and you have high-technology investments. You have all kinds of private investments out there.

Ms. SAWHILL. You don't have any control at all over what kind of private investments get made. In fact, the only thing that you know for sure is going to happen is that more public debt is going to be retired, and that should lower interest rates. There is not even any guarantee, by the way, that it will lower interest rates.

Representative HAMILTON. Wouldn't you by law have to set standards of private investments and qualified public investments? Wouldn't you have to do that?

Ms. SAWHILL. Absolutely not. Absolutely not. You are counting on an indirect mechanism here, which is lower interest rates, to encourage more private investment of all sorts. Now, some of that investment might be more examples of one company buying up another, using junk bonds for that purpose, and other investments might be much more productive, if I may make an indivdious comparison.

Senator BRYAN. Well, who would decide?

Ms. SAWHILL. The private sector would make all those decisions.

Senator BRYAN. I guess I am having difficulty—excuse me, Mr. Chairman.

Representative HAMILTON. I am having the same problem.

Yes, go ahead.

Senator BRYAN. Again, I think we have assumed that in 1993 we astonish the world by meeting the Gramm-Rudman-Hollings threshold and the operational provisions, as I understand it, go into effect and now we are off budget, a system that I happen to favor.

But now half of that surplus is in public and half is in private, but doesn't there have to be something akin to a board of directors or a policy group, or does the Congress do it? Who decides what goes into the private sector and what kind of public sector?

Maybe I am missing something, and I confess that I am very new to the Congress, but somebody has to make the decision, or is it all 535 of us making that decision each year?

Ms. SAWHILL. The Congress has to make the decision about what level of surplus they are going to shoot for and achieve in the unified budget. We can come up with a specific number consistent with my proposal.

Senator BRYAN. Whatever it is.

Ms. SAWHILL. Whatever it is.

That surplus means that the Government instead of being a net borrower in credit markets is a net supplier to credit markets in the amount of whatever surplus we are running in the unified budget.

Senator BRYAN. I think I understand that.

Ms. SAWHILL. Now, we are a net supplier to credit markets, meaning we can retire some existing outstanding debt held by the public. The widows that are out there holding Treasury securities and the insurance companies and other institutional investors that are holding them are now having the Government buy back some of this debt from them. This is putting a supply of new savings or credit into the private sector, helping to lower interest rates. Instead of the Government drawing on the private supply of credit it is instead adding to it. The lower interest rates this induces are what encourages more private investment, and it is the private market that makes those decisions.

Now, on the public side, how much we spend on more public investment depends again on that target that we initially set for what surplus to run in the unified budget.

Senator BRYAN. Mr. Chairman, perhaps I am beginning to understand. By using private versus public, you are saying that the decision by the Treasury or by the Congress to retire public debt, the little old lady who may have a previous bond or note or something like that, that is private investment.

I must say I didn't——

Representative HAMILTON. Yes.

Ms. SAWHILL. Absolutely.

Mr. MAKIN. I think, though, that the chairman asked a legitimate question. I just think if we are going to have to have this trust fund surplus, I would like to emphatically suggest that buying Treasury bonds and earmarking the interest for the trust fund is a far better idea than being tempted to put the Government in the business of investing this in a discretionary way or the Congress.

With all due respect, the Members of Congress write laws. They are not portfolio managers. Those guys are up in New York.

And essentially what you are doing—and I think what Ms. Sawhill is saying—is you are putting the money into the system. I mean, you buy Treasury bonds with it and essentially that is something that the Treasury doesn't have to sell to other people.

It is a little bit illusory, of course, when you are also running a deficit. You are only running a smaller deficit in the consolidated budget.

But I confess I am horrified by the idea of turning loose a group of public sector people with a $12 trillion trust fund or a $6 trillion trust fund to invest as they see fit.

Representative HAMILTON. If you look at Ms. Sawhill's prepared statement, she says:

"The proposal would be to use half of the continuing buildup in the trust fund . . . ."

What that conveys to me is the trust fund has a surplus in it, right?

Ms. SAWHILL. Yes.

Representative HAMILTON. And somebody has to decide what to do with that surplus. You are talking about a specific pot of money in the trust fund.

Ms. SAWHILL. Not quite. Let me make one correction.

Representative HAMILTON. Well, that is what you say, "continuing buildup in the trust fund."

Ms. SAWHILL. On an annual basis. In other words, it is each year's annual surplus.

Representative HAMILTON. All right.

Ms. SAWHILL. That is what I mean by the buildup, the buildup each year.

Representative HAMILTON. But it is in the trust fund?

Ms. SAWHILL. It is normally added to the trust fund under our current system each year, yes.

Representative HAMILTON. OK.

Mr. Ball.

Mr. BALL. I hope what I am going to——

Representative HAMILTON. I must say I am not clear. You have a buildup in the trust fund. There is a pot of money there, excess money, right? Surplus, that is what we are talking about?

Ms. SAWHILL. And we add to that every year that we have a surplus.

Representative HAMILTON. OK, and you are suggesting that half of that money go into public investment and half of that money go into private investment, right?

Ms. SAWHILL. Correct. It is a little more complicated than that, but I will for simplicity let you leave it there at the moment.

Representative HAMILTON. OK. But then who makes the decision what private investments you put the money into?

Ms. **Sawhill**. You are only making a decision to return the money to existing bondholders. There are a set of people and institutions out there who holds Treasury securities. All you are doing by making this decision to invest half of it in the private sector is buying back bonds from the public. That is all I am talking about. When you do that——

Representative **Hamilton**. What you are really proposing is a noninterventionist way for the Government to channel saving into the private sector?

Ms. **Sawhill**. Absolutely.

Mr. **Ball**. Mr. Chairman.

Representative **Hamilton**. That is a desirable thing. You and Mr. Ball would agree.

Is that a desirable thing, Mr. Makin?

Mr. **Makin**. I am not sure that you will have more savings as a result of bond redemptions because the surplus is created by taxing wages. You are taking money away from people and saying, well, we are taking 15 percent of your wages and we are going to provide for your retirement. So what is that person going to do? Are they going to save more or less? It is hard to know.

Mr. **Ball**. Mr. Chairman, I hope what I am going to say doesn't add to any confusion. I hope that it will be clarifying by making a contrast.

The increase in investment of the private sector is indirect—not what, say a State retirement system does, which directly decides to buy corporate bonds or buy corporate stock.

Senator **Bryan**. Well, that was my difficulty.

Mr. **Ball**. Yes.

Senator **Bryan**. I was having difficulty understanding investing in the private sector with retiring public debt.

Mr. **Ball**. None of us advocate direct investment in the private sector. It could be done, but it is very difficult, and if you go that way you raise the question of the Federal Government owning a large part of private industry before you are through. It raises the specter of socialism and all kinds of problems because the amount of money is so large.

So instead, when we say invest in the private sector—and I am in complete agreement with Ms. Sawhill on this—we would merely buy back publicly held debt. That would be the way we would do it.

The contrast is with direct buying of private securities and we wouldn't do that. There may be people who would advocate that, but none of us are advocating it.

Now, the difficult problem for the proposal is how to decide what you do about drawing a line between what is a government investment and what is a current operating expenditure.

Representative **Hamilton**. Well, how do you get the money into a higher volume of goods and services? That is what you want done with the money.

Mr. **Ball**. Yes, right.

Representative **Hamilton**. How are you sure that it gets there?

Mr. **Ball**. On the question of public investment, the only point you are sure about is that the future productivity of this country depends more than anything else on the capacity of our future citizens.

Representative HAMILTON. Future what?

Mr. BALL. Capacity—the ideas, the level of education, the ability to invent new things, to develop new technology.

Representative HAMILTON. Well, that is the question. How do you get the money there?

Mr. BALL. Now, through the Federal Government, various things I can think of do help—educational expenditures, job training expenditure, and investments in health. If we continue to do an inadequate job of prenatal care for all the women in this country—and we are not very good at it now—we increase the number of handicapped young people among our future citizens. That is not productive. It is quite the opposite.

Future productivity does not depend just on frozen capital. It is not a matter of more structures or machinery. Where the Federal Government contributes and where a lot of State expenditures contribute is to invest in people. That is one of the most productive things that we can do for the future: invest in people.

Representative HAMILTON. So we would take the surpluses in the Social Security trust funds, and one thing you say in your statement that we can do is to take that, buy up existing government debt, releasing private funds for investment in private industry.

That is one thing?

Mr. BALL. That is one thing.

Representative HAMILTON. But you are also suggesting now that you take those funds and we would make the determination——

Mr. BALL. Part of them.

Representative HAMILTON. Part of the funds and put additional funds into infrastructure, education, and so on?

Mr. BALL. Yes, and I think I recognize in my statement, Mr. Chairman, that it is difficult to draw the line between investment and current operating expenditures, and I think Ms. Sawhill was backing away somewhat from earmarking one-half and is now proposing that such a division be more of a goal.

But I want to be absolutely clear that on the private investment side none of us are suggesting the buying of stocks and bonds.

Senator BRYAN. That was my point.

Mr. BALL. See, in Sweden they do do that.

Representative HAMILTON. Well, of course the argument——

Mr. BALL. They take the surpluses and——

Representative HAMILTON. The conservative then is going to make the point that you are taking the revenues of government, the tax revenues of government, and pouring them into the social programs of the Government; right?

Mr. BALL. Certain social programs.

Ms. SAWHILL. Well, after all, I mean the Government is in the business of raising revenues to pay for social programs, including investment-type programs. We are already in that business, and I think many people have argued that one way to increase future productivity and future growth is to invest more in education and research and public infrastructure. That is not exactly a new idea.

We are only arguing that we may have starved those programs over the last 10 years.

I think it was John Makin who said that the growth of entitlement programs, most of which are oriented toward the elderly, have crowded out nondefense discretionary spending to the point where it is only half as much of GNP as it was, say, 10 years ago.

Representative HAMILTON. Well, I am thinking——

Ms. SAWHILL. Those are the investment-type programs.

Representative HAMILTON. I understand that. I am just thinking of the political burden of persuading people out here in the country that we are taking your payroll taxes that you think are going for your Social Security retirement and putting them into the welfare program.

Ms. SAWHILL. I understand your concern.

Representative HAMILTON. That would be my burden. See, that is my burden.

Mr. BALL. And in return for what the trust funds have lent the Government they now have a bond. It is difficult, Mr. Chairman, and I do have to add that several people, for whom I have great respect, say that because of this difficulty and the difficulty of distinguishing government investments from current operating expenditures they would put all the funds in the private field automatically as we have described.

Representative HAMILTON. I understand.

Mr. BALL. And there are many people who I respect who take that view. I would like to try to use part of the funds for government investment because I think these programs are so underfinanced.

Senator BRYAN. Could we pursue, Mr. Chairman, the private investments just one moment?

Representative HAMILTON. OK. Then we will go to Mr. Upton.

Yes, go right ahead.

Senator BRYAN. OK. With private investment, you in effect retire public debt, and that is presumably what increases the savings rate. How do we know that that necessarily follows?

Presumably we retire some public debt. What limitations, restrictions, indications, experience in the past do we have to rely upon that automatically that debt that is retired, which means more dollars in the hands of the previous holder of the debt instrument—doesn't just decide, well, I am going to add on to my house or buy a boat or get a fancier automobile? Is there a direct correlation? Can we establish that by doing it that that automatically becomes an increased pool of savings and increase our savings rate, which I think most of us recognize is dangerously low?

Then I will certainly yield to my colleague, and I apologize, Congressman.

Ms. SAWHILL. I think the best way to think about this is as the exact reverse process of what we did in the early 1980's when we ran large deficits in the Federal budget and as a result the Federal Government was a major actor, an increasingly bigger actor in the private credit market. If you believe that that raised interest rates, real interest rates adjusted for inflation, above what they otherwise would have been and had the effect of discouraging some private investments, then you would also believe that putting that process in reverse by running surpluses and retiring some debt should have the exact opposite effect.

Now, one of the things that we know that happened in the early 1980's is that interest rates, although they remained rather high in real terms as a result of the Government's large deficits, didn't remain as high as they would have if there hadn't been a substantial inflow of foreign capital to help us out.

Similarly, if we were to follow this proposal of running surpluses in the Federal budget, retiring debt, we would have to think about how much of that money was going to flow abroad to finance investment in other countries rather than investment in the United States. If a lot of it did flow abroad, then the impacts on domestic interest rates and domestic investment would be much smaller than otherwise.

My own view, however, is that there is plenty of evidence that there would be an impact on interest rates. Now, whether the investment that followed from that was productive or not, I think you would obviously get some that was productive and some that wasn't, and you would have a difference of opinion about what was productive.

I mean, if somebody added to their house, for example, some people would argue, well, that is just as productive as building a new factory. The stock of housing in this country is part of the assets we own. Others would say, well, no, that is not what we really need, we really need industrial investment to become more competitive and we need more of our savings to flow into business-fixed investment, less of it into building up the housing stock. So, you know, that becomes a debate.

Surely, it would flow into all those areas.

Mr. MAKIN. Could I make an addition?

I think the committee is rightfully uneasy and skeptical about two issues.

One, what is it that makes productivity grow? Because if we had some money around, it would be nice to put it into that.

I don't think economists, myself included, have an adequate explanation of the slowdown in the growth of productivity since 1975. I think we have an inkling that it has something to do with the shocks that came as part of the oil crisis and suggested that commodities were going to be more expensive, relative prices more volatile, and so on.

But I certainly would not be at all comfortable with the notion that part of the money be taken by any group of individuals, even folks who are professionals at it and who would say, well, we will put our bets on education or we will put our bets on this single horse and we are going to have higher productivity and higher growth. We do not know enough to do that. That is why we have a lot of smaller units fumbling around trying to find out what is the best bet.

Second, the notion that we can grow faster by investing more and accumulating more capital doesn't really square well with what we know about the sources of growth. Raw capital accounts for only about one-fifth of the growth of output in this country and elsewhere. Another third is accounted for by growth of labor, and the rest is accounted for by things that we don't know. So we call them technological change. That is a name for ignorance about what causes growth.

The notion that simply going out and buying more machines means that the economy is going to grow fast is certainly not consistent with any of the evidence that we have on what makes the economy grow faster. Here again we are essentially thrust back upon the notion that what tends to make an economy grow faster is having a lot of relatively small units trying to figure out how to make better mouse traps and going about it rather than having one big government agency that listens to people who say, well, I have an idea, will you give me some money. It doesn't work that way.

I think that one of my big complaints about the trust fund surplus is that it is a manifestation of a significant increase in the tax on labor in the United States, and it has induced our producers to substitute against labor in the production process because they know that the minute they hire somebody they are going to have to pay a 15-percent tax on the act of employing that individual. That is what the payroll tax is. And so when they think about producing, they think about how can we produce with as little labor as possible or maybe we ought to produce this thing in Taiwan or maybe we ought to import assembled components so we can make this product, this end product, by using less labor.

So here again if we say, well, we are going to tax, we are going to have a surplus, we are going to invest and everything is going to grow faster, that may or may not be true, but it is going to have to overcome some disadvantages that are already implicit in the way we gather up the money.

Representative HAMILTON. OK, Mr. Ball and then Congressman Upton.

Mr. BALL. I was just going to suggest that looking ahead at the labor market situation it may be not too bad to have incentives to substitute capital for labor. The growth of the one-third in our output that has come from our increase in the labor force in the past is likely to be grinding down, both because of the fact that young people as a source of new entrants to the labor force is coming to an end and that we may have gone almost as far as we can in the increase that comes from more participation on the part of women in the labor force. About the only place that is left is to have more older people work to get that part of growth which comes from an increase in the labor supply.

That leaves us with the 20 percent that comes from raw capital and the future possibilities of productivity increases from the area of technological development.

Representative HAMILTON. Congessman Upton.

Representative UPTON. Thank you, and I was sorry that I had to leave for a little while to go to the floor. I know I missed a fascinating discussion, and I will look forward to looking at it in the record when it becomes available.

Mr. Ball, I know that you played an instrumental part in the Social Security amendments back in 1983 in terms of the commission that was established, and I would like to look back and get your thoughts.

When was it that we really began to know how big that surplus was going to be?

I only recall reading about these tremendous surpluses only really in the last 2 or 3 years. Did the commission back in—when you did all the work back then, did you all realize the surpluses that were going to be building up back then?

Mr. BALL. Congressman Upton, it is not a simple "yes" or "no" answer, like so many other things.

The commission was focused, first of all on making sure that there was enough funding to get the system through a short-term crisis. In 1983, the greatest interest was to get into the next century, to make sure the system was sound through the 1990's.

I, to some extent, acted as sort of a chair and staff director for those who had been appointed by the Democrats, and Alan Greenspan, the chairman of the commission, practically filled my office with machine runs from Commerce testing all kinds of assumptions for our recommendations running out through the 1990's. We all became convinced that the solution we proposed would make it through the 1990's under about any set of circumstances.

We deliberately picked very pessimistic economic assumptions because we thought the worst thing that could happen—not just for Social Security but for the confidence of the country in its government—would be to run into another Social Security crisis after 1981 and 1982. So we deliberately picked very pessimistic assumptions to get through that short term. By short term, I mean through the 1990's.

Now, it turned out that not only did the economy do better than those pessimistic assumptions. It did better even than reasonably optimistic assumptions. We have had very sustained economic growth ever since the 1981–82 very serious recession, so that the surpluses that are building now and through the 1990's are much larger than we anticipated.

It is also clear from the record that the commission was very much concerned about the longrun stability of Social Security through the whole 75 years over which the estimates are usually made. We could not agree among those appointed by Democrats and those appointed by Republicans on exactly what should be done about the long term but we agreed that the financing should be provided. The proposals that we agreed on solved about two-thirds of the long-range problems. Then each group had its own proposal. There were two sets of proposals in the report to solve the remaining one-third of the long-term deficit. The Congress elected to accept the solution of those appointed by Republicans, which was to increase the retirement age. Under the way the estimates were made, gradually raising the age at which full benefits were paid to 67, carried the system through the whole 75 years. From 2000 on, middle-range economic assumptions rather than pessimistic ones were used.

The plan produced this peculiar financial buildup and then a dissipation of the funds. The plan worked through the 75 years, but not beyond.

The fundamental issue of whether to stay largely on "pay as you go" for the long run or have a partly funded system was not directly addressed by the commission. It rather accepted whatever financing there was in the law and then worked on how to increase income further, reduce benefits and meet the deficit.

So it was recognized that the scheduled 1990 rates, coming in as they did at a time when demography was favorable, was going to build annual surpluses. It was recognized, but nobody proposed avoiding it because then you would have had to have higher rates later on and even more of a financial problem for the commission to solve.

Representative UPTON. Did they actually forecast that at the year 2031 it would—I mean back then—when it would hit the break-even point and then start dipping down below the line?

Mr. BALL. I have forgotten exactly what the year was, Congressman Upton, but we certainly knew and the actuaries had supplied us with the information—the chief of staff of the commission was the chief actuary of the Social Security Administration for several decades—we certainly knew that that was the pattern. It probably wasn't 2030. It may have been some year right around there when it stopped building and then came down.

I do not consider that a desirable arrangement myself.

Representative UPTON. Well, as probably the one with the most personal interest at this table, I will be 78 in the year 2031. [Laughter.]

At what point—you referenced a little bit when I was here earlier about you hoped that we would not change OASDI and taking it off from the rates—at what point do you think in the next 20 or so years should—if—should Congress begin to examine that "drop dead" date of the year 2031? What suggestions would the rest of the panel envision as well as to what options we should seriously consider other than increasing the retirement age? Do you think that we should take a serious look in the next couple of years of freezing COLA's, means testing COLA's for those at a certain level, $40,000? Should we continue to increase the surplus, take steps to increase that surplus in the 1990's or the early 2000's to extend that year 2031?

Mr. BALL. You need to worry a little bit more about your children than yourself.

Representative UPTON. Yes, I hope so.

Mr. BALL. It isn't a 2030 drop-dead date; 2030 is the time at which the trust funds will stop——

Representative UPTON. Building up its——

Mr. BALL [continuing]. Building. Under the middle-range estimates there are sufficient funds to pay benefits into the 2040's by cashing in bonds.

But let's not take too seriously these exact dates that are way out that far. Obviously, nobody knows what is going to happen that far away. These are very rough approximations. Currently, they talk about the system running out of money in 2046 in the 1989 report, I believe. I don't take that too seriously within 15 years one way or the other.

But the slope of the curves is clear. What would I do about it?

The last thing I would do about it is the idea of reducing the cost of living adjustment.

Representative UPTON. Even means testing?

Mr. BALL. And means testing. That is even worse.

Representative UPTON. Yes.

Mr. BALL. Means testing would end the system. You would lose the support that the program has generally among the American people. I do not consider something like taxing benefits means testing at all. Private retirement benefits are taxed. Your wages are taxed. It is perfectly reasonable to tax the benefit income. That is not means testing.

Means testing is denying a benefit or reducing a benefit because you have saved your money and because you have more than a certain income at the time that you apply for benefits.

Now, the reason I say next to the means test, which ruins the whole system, that a COLA reduction is, in my judgment, the worst idea around is that you pay people lower benefits—because purchasing power is all that matters—lower benefits when they are 75 or 80 than when they first came on the rolls or a disabled person who is disabled at 35, less at 50 than you paid him or her at 35.

If the benefits are too high—and I don't believe they are, the retirement benefits average about $525 a month—but if they are too high, they should be lowered, but in any event they should be maintained at the purchasing power level of that benefit out through the retirement years and out through the beneficiary years of a disabled person or a survivor.

I am not making this big plea to argue that it would be a terrible disaster to have a one-time skip in the COLA. I don't want it, but that doesn't undermine the program as would a basic change such as permanently granting only a cost of living minus 2 percentage points or 60 percent of the cost of living, as suggested by Peter Peterson. I think such changes are among the worst ideas around.

Now, on the other hand, there are a few good ideas on how to improve the financing. One that is popular in some States and unpopular in others would be to extend the Social Security system to the 30 percent of State and local employees that are not now participating in it. I would do it on the same basis that Federal employees were covered in the 1983 amendments; that is, new employees would be covered for OASDI as already new State and local employees are covered for Medicare. This change would increase the income to the system. It increases income over the long run, too; it is not just short term.

Another thing, as I suggested earlier, is that I would increase the tax on the benefits of higher income people, with that additional money, as under present law, going back into the Social Security system and improving the financing of the program. About seven-tenths of the cost of Social Security in the future will be met by the taxation of benefits as presently designed. You can considerably increase that if you applied the same rules to Social Security as are applied to private retirement systems.

But I do not consider the level of promised benefits too high for a basic system. I don't take the view that the goal of the system is more subsistence. The abolition of poverty among the groups covered by Social Security, survivors and disabled and the elderly, is a very important objective. Social Security is the greatest antipoverty program we have, but it goes way beyond that goal.

For average and below-average earners it is the only retirement system. That is all most of them have. Average and above-average earners—where Social Security supplies a lower benefit in relation to what you pay because of the weighted benefit formula—is supplemented usually by private pensions and by the individual's own savings, so that the combination of the weighted benefit formula for the lower paid and supplementation for above-average earners gives you a basically good replacement rate throughout the whole range of earnings.

I think what we ought to do beyond these few things I have mentioned is to continue a relatively modest but adequate base of Social Security benefits. I believe that the best way to do that is a rate increase when you reach this point of 2030—I would propose putting it in the law now so it is clear to people. A contribution rate increase at that time of about a 1 percentage point on employers and 1 percentage on employees would do the job.

That is not a great big deal. We are at 5 percent unemployment in spite of the litany of problems that are recited by some people to result from the payroll tax. Our unemployment rate is not much too high.

Representative Upton. Mr. Makin.

Mr. Makin. I think that when you think of $12 trillion it is much better to put it in current dollars. Inflation is a large part of that increase. In current dollars the trust fund buildup would be around $2.7 trillion. If you add in the problems with the—and I mean problems—with the Medicare trust fund you are at about $1.5 trillion.

So we can certainly easily dispose of the idea of what if we run out of government securities to buy with the trust fund; $1.5 trillion, which is the net is about 30 percent of 1 year's GNP. So it is not a terribly daunting large number.

Now, the options available when the surplus is exhausted are always the same. You can raise taxes, you can cut benefits, or you can think about a new system. Let's talk about adjusting benefits. The options are a 1-year COLA skip. I know a number of individuals who are no longer in this body who contemplated that notion in 1985——

Representative Upton. That may be the reason. [Laughter.]

Mr. Makin [continuing]. Because they became the target of a very well-financed lobby.

But there again, I think that if you are going to do something on the outlay side a 1-year COLA skip is superior to the minus 2 option because it preserves the age profile benefit.

By the way, if we had done a 1-year COLA skip in 1985, we would be considerably closer to realistically meeting the Gramm-Rudman targets than we are today.

Older retirement. I know you can say, well, we have a great problem and if you live to 80 you get benefits. We can always raise the age of retirement. There again you are essentially changing the contract. You are saying to individuals that we can't pay for it. So we are going to have you retire later.

I think one thing that ought to be done with benefits within the context of the existing system. Benefits should be indexed to real wages and not inflation. The tax base is wages. The problem is that and we cannot afford this system because we contemplate it financing benefits for children of baby boomers without either benefit cuts or tax increases. So that defines something we can't afford.

The reason we are in that situation is that between 1969 and 1980 there were two 5-year periods during which benefits rose a lot faster than wages. So we had to raise taxes.

Let's talk about the tax side. You can raise the payroll tax. I think that I would invite any Member of Congress who thinks it won't be a problem to add 1 percent to the employer contribution and 1 percent to the employee contribution to propose such a measure this year. Step right up.

I don't think that would be any more popular than a COLA freeze or a COLA minus 1 or a COLA minus 2. So if you as the Members of Congress are sitting here and saying, well, there is no politically viable expenditure cut or there is no politically viable tax increase to deal with the problem that we know is coming, maybe you ought to think about a different system.

Representative UPTON. Do you have some comment, Ms. Sawhill?

Ms. SAWHILL. I think I mostly agree with what Mr. Ball said. I think we are going to need a combination of benefit reductions and payroll tax increases and that if we use that combination neither side of the equation has to bear that much of the burden.

I totally agree with the idea of maintaining a cost of living adjustment. I think we should, as I said before, tax benefits more fully, and I think we should increase the retirement age a little more than is currently planned.

My understanding of the current proposal is that starting in the year 2000 we increase the retirement age first from 65 to 66 gradually, 2 months at a time. Then there is a period in which we level off and leave it at 66, and then we begin another period in which we increase it from 66 to 67, again at this gradual rate.

My colleague, Rudy Penner, has put together a proposal which says let's smoothly and continuously increase the retirement age at a rate of 2 months a year, and if you do that you get quite a bit of financial bang for the system.

The reason I don't think this is totally a breach of our contract with the public, as Mr. Makin has suggested, is because people will live longer and are living longer, much longer than when the system was first set up. So the expected value of the benefits that you receive at 65 are now much higher than they were at an earlier period when people didn't expect to live as long. They didn't collect the benefits for as many years, and by 2030 the number of years over which the average recipient collects benefits is going to be still higher.

So it seems to me perfectly fair to take that into account now and forewarn people that we need to increase the retirement age for that reason.

The other thing is that you continue to have an option to retire early with actuarially reduced benefits. Given that people have that option, it is the case that this proposal is almost synonymous with saying we are changing the benefit formula a bit so that benefits aren't quite as generous. People still have the option to retire early with lower benefits if they want to.

Representative HAMILTON. Do we have to worry about any impact of the trust fund buildup on economic growth or other economic problems? Is that a factor for us? Are there macroeconomic implications here?

Mr. BALL. Well, I think two of us think that it helps economic growth if you take other actions.

Ms. Sawhill. If I could just comment a little further on that, I think Mr. Makin is very skeptical about whether or not increased capital formation leads to more economic growth, and he is quite right that we don't understand all the reasons for the productivity growth slowdown after 1973. However, I think there is a strong consensus within the economics profession that more capital formation generally does increase the rate of economic growth, and particularly if one is worried about technological progress, many people would argue, with some merit, I think, that a lot of technological advances are incorporated in new investment and that therefore investment takes on more importance as a source of economic growth than the standard calculation that it is only one-fifth of national income would suggest.

Mr. Makin. If I just may make a germane comment, actually Chuck Halton has just finished a study for us on that very issue, which I wish it were more encouraging but I am afraid that that may be a vain hope.

You know, there is a way to raise saving in the United States that would perhaps be consistent with some of the ideas that my fellow panelists are suggesting, and that is to put the age at which benefits begin significantly above the average retirement age.

This is the situation in Japan. Typical retirement occurs at age 55 and benefits begin at age 60. And one of the reasons that individuals in Japan do save more is because they have a long hiatus period before their benefits kick in.

I mean, one could say, well, that is a facetious proposal. It really isn't. It suggests what is really a problem here; that is, we all say that more saving is good, but few of us do it unless we are compelled to do it, and one of the ways to compel us to do it is simply to face us with a situation where we are going to provide on our own for a period during which there will be no other source of income, and this is really the whole issue here.

We are here today and talking about the trust fund surplus, and what we are really talking about is whether providing for consumption over a life cycle is better done through a compulsory means by the Government or would be better done by individuals. I think we do have a social consensus that we don't want to be terribly rigid and say, well, if you didn't save and you are age 65, you can starve.

We certainly are not saying that, but the question is how generous are we and what is politically viable. I keep coming back to the notion because when we look at the system and we say, well, we will raise taxes or cut benefits, I think that the members of this body know well that it is not necessarily politically viable to make major changes in that system. That suggests a need to reexamine the system and perhaps make some changes in either the way it is financed or in the level of benefits.

Representative Hamilton. I want to conclude pretty quickly here, but I would like to get your comment, Mr. Ball, on a comment in Mr. Makin's statement about the Social Security system being unfair. He makes two points there, I think, at least. One is that it is unfair because of the payroll tax at 15 percent, and he gives the illustration on the first $45,000, half of which is paid by employee, half by employer. For an individual earning $45,000 or less the payroll tax is 15 percent. An individual earning $90,000, the payroll tax is only 7.5 percent of income.

So it is unfair with regard to the payroll tax.

The second point is it is unfair because current beneficiaries receive about $3 for every $1 contributed, and by the time the baby boomers retire the ratio will be down to about $1 per $1 contributed.

Mr. BALL. Mr. Chairman, I disagree with the characterization. The facts are correct. It seems to me that in starting out a system like this or a private pension system, for that matter, you have the choice of waiting a generation or two or paying people in the first generation more than they and their employers have paid in. The solution that private pensions invariably take is that the employer picks up what are called past service credits, even in a contributory system, and so people who are near retirement age get much higher benefits compared to what they pay than people who come later.

Social Security did the same thing. It paid the first generation and the second generation——

Representative HAMILTON. It is really a windfall for them.

Mr. BALL. If you look at it entirely in terms of a contribution to benefit ratio, that is true.

I look at the system not entirely that way, but in terms of reward for past work, benefits growing out of earnings, and how you finance it as a secondary consideration really. Those who set up the system did not breach the idea that benefits went only to people who had earnings and that the benefits were a proportion of those earnings, but there was a break certainly, a very big break for people in the first generation or two in terms of the ratio of benefits to contributions.

Now, we are getting to a mature system, and young workers are going to be paying just about—they and their employers together—the value of the protection. That seems perfectly all right to me.

On the other point——

Representative HAMILTON. The tax point?

Mr. BALL. On the tax point it depends on how you look at this system. I don't think that progressivity is necessarily the best way to finance everything. More progressive seems always to equal good and less progressive to equal bad. I do not necessarily believe that.

If you look at this system as a contributory system with a relationship between benefits and contribution, the cutoff point, $48,000 this year, is a cutoff point not only for what you pay, but for the credits that you get toward benefits. Now, if you are going to go higher, you have two possibilities:

One, you can just have the tax go higher and tax people who make $100,000 a year but not increase their benefits, only credit them half of that. You would ensure then that they were not getting anywhere near their money's worth under the program, and a whole lot of people in between would not be getting anywhere near their money's worth under the program.

I think that would be a weakening factor in the way people would look at the system. If you want more progressivity in Social Security financing—and I am not in favor of it, I think the present setup is fine—I would rather have a general revenue contribution which comes from all sources. But I am not inclined to favor that. I did at one time, but I am not inclined to favor it now.

But it is true that the fact that both benefit credits and contributions stop at a given wage level make the financing not progressive from then on, but I think it is OK.

Ms. **Sawhill**. A quick comment on that, Mr. Chairman.

Representative **Hamilton**. Sure. I will ask for any concluding comments you want to make here.

Ms. **Sawhill**. Although I am concerned about this progressivity issue, just for the record, I think it is important to point out that the proportion of the labor force with earnings above the $48,000 threshold is very small. We are not talking about family income. We are talking about individual earnings. By Washington professional standards that may seem like a relatively low level of earnings. In the country as a whole, however, there is a very small proportion of the population earning above that level.

Mr. **Ball**. About 7 percent.

And I should have made the point, Mr. Chairman, too, that if you look at the system as a whole, it is progressive. The benefits in relation to the contributions you make are much higher for low-wage earners than for the higher paid. So you have a total system that is progressive. The other point is that if benefit credits are allowed to increase with tax payments above the present maximum, benefits get very high for the highest paid workers—a questionable result for a social insurance system.

Representative **Hamilton**. Any concluding comments?

Mr. **Makin**. Well, actually that is not correct because your lowest income workers tend to enter the system at a much earlier age, and so they pay into the system over a longer period of time. That is, take an individual who goes to work right after high school, gets a job, starts contributing to the system at age 18 or 19, pays in more to the system relative to benefits than the individual who gets college or graduate education and enters the labor force at age 22, 23, 24, or 25.

If you do the calculations, you will find that the rate of return to the system to individuals with college educations is higher than it is to individuals who don't have college educations, largely because of the age in which they enter the system.

Mr. **Ball**. Not for new entrants now. It is true that the higher paid have more of the break that we were talking about earlier, but you have to take the whole system into account.

The point that you are making, Mr. Makin, leaves out disability and survivorship. These same people tend to have larger families. The disability rates are higher. If you take the whole system, the later age of labor force entry does not by any means overwhelm the weighted benefits.

Mr. **Makin**. It is, however, a mitigating factor.

Mr. **Ball**. It is mitigating.

Mr. **Makin**. I think my final point is a very simple one, and that is I think we need to rethink the system, and I think both on economic grounds and on political grounds. If a system cannot survive unless participation is compulsory, then in a democracy I do not think it is a system that should be left unexamined.

Representative **Hamilton**. Any other comments?

[No response.]

Representative HAMILTON. We have had a good discussion this morning.

Thank you very much.

Ms. SAWHILL. Thank you.

Mr. BALL. Thank you, Mr. Chairman.

Mr. MAKIN. Thank you.

Representative HAMILTON. The committee stands adjourned.

[Whereupon, at 11:47 a.m., the committee adjourned, subject to the call of the Chair.]

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